DEPARTMENT OF THE TREASURY

Report to the Congress

on

International Economic and Exchange Rate Policy

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PART I: INTRODUCTION

Section 3005 of the Omnibus Trade and Competitiveness Act of 1988 (Pub. L. 100-418) requires the Secretary of the Treasury to submit to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives a report each October 15 on international economic policy, including exchange rate policy.

The initial report was submitted in October 1988 and provided an analysis of exchange market developments, including the underlying economic factors and the impact on the U.S. economy; an assessment of which countries were "manipulating" exchange rates within the meaning of the legislation; and recommendations for changes in U.S. economic policy to attain a more appropriate and sustainable current account balance.

Section 3005 also requires the Secretary to provide a written update of developments 6 months after the initial report. This report provides such an update. Part II reviews recent developments in the world economy, including developments in the U.S. balance of payments and efforts by the major industrial countries to coordinate economic policies. Part III analyzes the situation in the foreign currency markets, including the impact of changes in the exchange rate for the dollar on the U.S. economy. Part IV provides a status report on negotiations with Korea and Taiwan, economies which were considered in the October report to be "manipulating" their exchange rates, within the meaning of the trade legislation. The final part provides conclusions on the principal issues discussed in the report.

PART II: WORLD ECONOMIC PERFORMANCE AND OUTLOOK

Global Economic Developments

o Overview

The economic expansion in the industrial countries that has been underway for six consecutive years strengthened substantially in 1988, contributing to a very strong increase in world trade growth and helping the Less Developed Countries (LDCs) record their highest growth rate of the decade. In addition, the pattern of growth both within and among the seven largest industrial economies last year provided essential support for global current account adjustment. The U.S. current account deficit was reduced considerably in 1988 while the surpluses of Japan, the European Community and the four Asian Newly Industrialized Economies (NIEs) also declined. Consumer price inflation in the industrial countries picked up slightly again in 1988, albeit to a rate that was only slightly above the 20-year low reached in 1986. (See Table 1.)

The basically favorable macroeconomic trends that were evident in 1988 have generally persisted thus far this year, promoting confidence that industrial country growth will continue, albeit at a more moderate pace, at least into 1990. Partly as a result, the LDC economies and world trade should return to their more moderate 1987 growth rates.

However, the international pattern of growth will probably be somewhat less favorable for current account adjustment than was the case last year. Thus, while the external adjustment process is expected to continue in real terms in key countries, further large reductions in major current account imbalances are not anticipated this year.

The available evidence suggests that, while inflationary pressures bear close watching in some countries, the average industrial country inflation rate will pick up only modestly this year, to just below 4 percent. There is little evidence that a serious general acceleration of inflation is developing.

o Expansion Continuing at a Sustainable Pace

Real GNP rose 4.2 percent (annual average) in the seven largest economies in 1988. Expectations earlier in the year that the stock market break of October 1987 would have serious negative repercussions on industrial country macroeconomic performance were not borne out by events. Indeed, consumer and business sentiment improved substantially and generally remains good.

In addition to being stronger than initially anticipated, industrial country growth in 1988 was also better balanced internationally and therefore more supportive of global current account adjustment. In the United States, domestic demand growth was more moderate (3.0 percent) than in the earlier years of the current expansion, thus helping reduce the growth rate of nominal imports and making domestic productive capacity available to meet substantially higher foreign demand for U.S. products. The sharp improvement in U.S. net export performance last year accounted for nearly 1 percentage point of last year's 3.9 percent total GNP growth rate.

The Japanese economy, conversely, was led by a sharp increase in domestic demand while the external side exerted a strong net contractionary effect. Despite tax cuts in Germany, domestic demand growth was only slightly above GNP growth, and external developments had an essentially neutral impact. In the remaining major industrial countries, the difference between domestic demand and GNP growth was somewhat larger than was the case for Germany, particularly in the United Kingdom.

Growth prospects for the industrial countries remain favorable for 1989. GNP growth is projected to return to a more moderate and sustainable 3 to 3-1/2 percent range as private consumption growth moderates slightly and fixed investment slows from last year's exceptional pace. Japan will again be the G-7 growth leader for both GNP and domestic demand. In Europe, the growth slowdown is expected to be particularly evident in Germany and the United Kingdom.

The basic composition of industrial country growth outside of the United States this year (i.e., domestic demand growth in excess of GNP growth) is expected to be qualitatively similar to 1988. However, the projected slowdown of consumption and investment implies a more measured pace of domestic demand growth, which will narrow the amount by which it exceeds GNP growth.

o <u>External Adjustment at More Measured Pace</u>

One of the most favorable aspects of global economic developments in 1988 was the sharp increase in world trade growth, which both resulted from and contributed to the stronger and more balanced overall growth performance. The latest IMF estimates indicate that world trade volume increased by 9.3 percent in 1988 after a healthy 6.1 percent gain in 1987. This strong advance largely reflected developments in the industrial countries, which account for nearly 75 percent of total world trade.

These trade developments were reflected in significant shifts in the current account positions of major countries and country groups. The U.S. current account deficit declined about $20 billion, while Japan's surplus declined $7.5 billion and the combined surplus of the four Asian NIEs by about $4-1/2 billion, despite sharp growth in Korea's surplus. Europe's aggregate current account surplus was reduced by roughly $20 billion, though this was accounted for almost entirely by a very sharp increase in the deficit of the United Kingdom; Germany's current account surplus rose nearly $4 billion to a large record high of around $48-1/2 billion.

External adjustment in the major countries can also be gauged by considering current account imbalances as a percent of GNP, which eliminates valuation problems associated with exchange rate changes and takes into account the differing sizes of national economies. By this measure, the U.S. current account deficit declined from its 1987 peak of 3.4 percent of nominal GNP to 2.8 percent last year; Japan's surplus dropped from 3.6 to 2.8 percent (vs. its 1986 peak of 4.3 percent). Germany's surplus remained unchanged at 4.0 percent of GNP, though this was down somewhat from its 1986 peak of 4.4 percent.

Two emerging trends suggest, however, that while global current account adjustment is expected to continue this year, the pace of adjustment may slow somewhat. First, the projected narrowing in the difference between domestic demand and GNP growth in the major surplus countries will tend, <u>ceteris paribus</u>, to reduce the macroeconomic impetus for large additional shifts. Second, while U.S. export growth strengthened substantially in 1988, so too did export growth rates in most of the other major industrial economies, including the major surplus countries.

o <u>Inflation Remains Modest and Contained</u>

Consumer price inflation in the major industrial countries averaged about 3.1 percent in 1988, only slightly higher than the 2.8 percent recorded in 1987. Rates in Japan and Germany were exceptionally low, even by historical standards, averaging around 1 percent. France continued its impressive progress, holding its inflation rate below 3 percent. Rates in the United States and Canada both averaged near 4 percent, and around 5 percent in Italy and the United Kingdom.

Inflation rates in the major industrial countries have increased somewhat during the past 6 months, generating concern in some quarters about a potential serious deterioration on the price front. Average inflation in the industrial countries is expected to rise only modestly this year, however, probably remaining below 4 percent. While the situation bears close attention in some countries, some factors suggest that there is not now a serious risk of a general acceleration of inflation.

First, slower GNP and domestic demand growth this year will ease some of the demand-side pressure that may have been emerging last year. Second, and related to this, monetary authorities in the key countries have been pursuing policies of restraint. Third, despite some recent increases, unit labor cost developments have been quite moderate. Fourth, the OECD-wide surge in investment last year should help ease production bottlenecks that may be emerging in particular sectors.

<u>U.S. Trade and Current Account Developments</u>

o <u>Developments in 1988</u>

The U.S. trade deficit peaked in real terms in late 1986, and a year later in value terms. It then declined markedly in 1988.

The improvement in the U.S. trade deficit (nominal terms) in 1988 was broadly-based in geographical and product terms, and involved substantial increases in exports and slower import growth. For 1988 as a whole, the trade deficit declined by roughly $34 billion, from $160 to $127 billion, as exports grew strongly (28 percent in value terms), while imports grew less than one-third as fast. In volume terms, exports were up 23 percent, while imports increased 7 percent.

The trade deficit in 1988 decreased with every major geographic area, with the strongest declines vis-a-vis Western Europe, Latin America, and Japan. The improvement also covered a wide range of products. Only consumer goods, among major product groupings, failed to show a reduced defict in 1988.

Strong export growth was broadly-based in terms of both product categories and geographic regions. Past exchange rate changes played a major role in enhancing U.S. competitiveness in 1988. Our export competitiveness was complemented by strong domestic demand growth in industrial countries -- especially Japan -- and a revival of exports to Latin America, particularly to Mexico.

The more subdued rate of import growth for the United States in 1988 reflected in part the lagged effects of past exchange rate changes and lower average oil prices. Auto and consumer goods imports increased only slightly in 1988; a surge in these two categories had been a major contributor to the widening of the trade deficit during 1983-87. Capital goods was the one product category registering strong import growth in 1988, reflecting strong capital equipment spending by U.S. firms.

The pace of improvement in the trade balance, however, slowed in the last half of 1988. After remaining essentially flat at fourth quarter 1987 levels through the first three

quarters of 1988, import growth picked up in the fourth quarter of 1988, largely in finished manufactures. Export growth, though still robust, moderated somewhat in the latter part of 1988. Exports in the first half of 1988 were up over 32 percent in value terms from the first half of 1987, while second half exports were up 24 percent from the same period in 1987.

The U.S. current account deficit also declined in 1988, though less dramatically than the trade deficit, falling by roughly $20 billion, from $154 to $135 billion. This outcome reflected the net effect of the trade balance improvement discussed above, and a switch from surplus to deficit on trade in services. The adverse shift on the services account reflects the fact that the traditional U.S. surplus on investment income has been eroded, along with the U.S. international investment position, as borrowing from abroad has been needed to finance continued U.S. external deficits. (See Table 2.)

With respect to capital flows, the recorded net inflow in 1988 declined by about $17 billion, roughly equal to the decrease in the current account deficit. This was accompanied by a substantial shift from official to private net inflows. Official net inflows declined in 1988, while overall private inflows were unchanged. Within private capital, direct investment and securities transactions registered an increased net inflow, while banking inflows declined. By category, the largest changes in non-official flows were: increased foreign purchases of U.S. Treasury securities, more than offsetting a decline in purchases of other U.S. securities; a substantial decline in U.S. direct investment outflows; and a significant increase in net lending abroad by U.S. banks. (See Table 3.)

o Prospects for 1989

In view of recent developments, including higher oil prices and other factors, improvements in the U.S. trade deficit for 1989 which had earlier been expected may be partly offset. The outlook for trade and current account adjustment through the end of this year will be influenced by a number of major factors, in addition to oil prices. These factors include the prospects for sustained growth abroad, especially in Europe; exchange rate developments; progress with Korea and Taiwan on market opening and exchange rate adjustment; and sustained growth in major LDC export markets.

At home, success in reducing the budget deficit will be a critical counterpart to progress in these other areas. The recent bipartisan agreement on a budget framework for Fiscal Year 1990 between the President and the joint leadership of the Congress represents an important step in meeting the deficit reduction targets of the Gramm-Rudman-Hollings law.

Economic Policy Coordination

The major industrial countries are continuing their efforts to coordinate economic policies to achieve shared objectives. The coordination process has now become an accepted feature of the international economic landscape with regular meetings of finance officials from the Group of Seven countries (United States, Japan, Germany, France, United Kingdom, Canada, and Italy). A sign of the growing maturity and acceptance of the G-7 process, for example, was demonstrated by the meeting in February where no communique was issued and without the market instability that would have followed such a development in the past.

The recent meetings of the G-7 in February and again on April 2 have focused on efforts to maintain the substantial progress achieved in 1988 in dealing with global economic problems. Last year represented a notable success for the coordination process, as documented in the October report. Economic growth exceeded expectations and inflation remained in check. External imbalances were reduced substantially and exchange markets were generally stable.

However, sustained noninflationary growth -- which remains the central objective of the coordination process -- will require continued efforts. The success of these efforts depends on continued progress in controlling inflation and gradually reducing external imbalances. While reductions in external imbalances were achieved last year, further progress in this area is required.

- o Countries with large fiscal and trade deficits, especially the United States, but also Canada and Italy, need to make further reductions in budget deficits to complement monetary policies. Implementation of the recent bipartisan budget framework agreement between the President and the joint Congressional leadership will be crucial to achieving further reductions in the U.S. budget deficit.

- o The major surplus countries should pursue economic and structural policies that will sustain domestic demand growth without inflation and facilitate external adjustment; and

- o All countries need to pursue structural reforms.

The coordination process has resulted in more effective arrangements to deal with exchange market pressures. As discussed in the next part of the report, exchange markets have been more stable over the past year, thus contributing to and benefitting from the progress in sustaining the global expansion

and reducing external imbalances. The G-7 agreed at their April meeting that a rise of the dollar which undermined adjustment efforts, or an excessive decline, would be counterproductive and reiterated their commitment to cooperate closely on exchange markets.

PART III: FOREIGN EXCHANGE MARKET DEVELOPMENTS

Overview

During the last 6 months, exchange markets have been generally stable. The dollar appreciated by about 5 percent against the Japanese yen and 4 percent against the German mark, but on a trade-weighted basis in nominal terms is little changed against major currencies. (See Table 4.)

Trends in exchange markets over this period can be subdivided into three distinct periods: 1) from October through mid-December when the dollar experienced selling pressure; 2) from mid-December through March when the dollar strengthened; and 3) since the beginning of April when the dollar eased from its end-March highs, but continues to be in good demand. Trading conditions throughout the period were influenced primarily by developments and market expectations regarding U.S. economic growth, inflation, monetary policy, and interest rates.

In market intervention, the U.S. monetary authorities made net purchases of about $0.7 billion from October through January. They purchased about $2.6 billion ($2.0 billion against yen and $0.6 billion against marks) to support the dollar against selling pressure during October-December, and sold about $1.9 billion against German marks in January as the dollar rose.

October through Mid-December

The dollar started declining in early October following evidence of slowing U.S. economic activity, which the market regarded as reducing the likelihood of monetary tightening. By mid-October, selling pressure on the dollar had emerged in response to diminishing prospects for higher dollar yields and market perceptions that U.S. monetary authorities might tolerate a gradual easing of the dollar ahead of the election, particularly because of concerns that adjustment of world trade imbalances was slowing. Furthermore, private analysts suggested that it would take a further dollar decline to narrow the U.S. external deficit. After the election, market attention shifted to concerns about the U.S. budget deficit, stimulating further dollar selling. Concerted intervention purchases of dollars by G-7 monetary authorities during the period made the market cautious about selling the dollar aggressively.

Mid-December through March

In December market sentiment changed, with participants taking the view that the G-7 monetary authorities would concentrate more on adopting anti-inflationary policies. Economic indicators showed that U.S. economic activity, though

moderating, remained robust. Dollar demand quickened on the market's belief that the Federal Reserve would tighten its monetary stance further. At mid-month, the Federal funds rate rose from under 8-1/2 percent to near 9 percent. However, in view of coordinated interest rate hikes in Europe, interest differentials favoring dollar placements against European currencies initially narrowed. There was no appreciable change in interest differentials against the yen.

Toward mid-January, the market turned increasingly bullish on the dollar. There was growing optimism regarding the United States' willingness to tackle its fiscal deficit. Also, "safe haven" demand related to tensions in the Mediterranean was appreciable. Meanwhile, comments from various G-7 officials were interpreted as indicating a tolerance for further dollar appreciation. Reports of concerted intervention sales of dollars during January and early February braked the dollar's upward momentum.

Subsequently, additional data interpreted as suggesting that inflationary momentum may have increased in the United States encouraged further expectations of monetary tightening by the Federal Reserve. Chairman Greenspan said that the Federal Reserve would err on the side of monetary restraint. The Federal Reserve progressively tightened the Fed funds to levels over 9 percent and, in late February, raised its discount rate by 1/2 percentage point to 7 percent. Meanwhile, Germany and Japan signalled that they would avoid further tightening of their monetary stances. Interest differentials against the German mark and the Japanese yen then began to widen significantly and, by late March, were approximately 1/2 percentage point higher than in late February.

<u>Since End-March</u>

After reaching its highs for 1989 in late March, the dollar eased back in early April. Following the G-7's statement of April 2 and subsequent reports of intervention sales of dollars against yen as well as marks, the market perceived that the G-7 monetary authorities would regard further dollar appreciation as counterproductive to global adjustment of external imbalances. Also, prospects for a further widening of interest differentials in favor of the dollar were viewed by market participants as mixed, given that U.S. economic indicators were seen as pointing tentatively to moderating U.S. economic activity.

<u>Effects of Exchange Rate Changes on External Positions</u>

Despite recent movements, the dollar remains roughly at 1980 levels in real terms. On average, the appreciation of the dollar in the early and mid-eighties against our major trading partners has been reversed.

Exchange rate changes since October have, on balance, been minor, and exchange rate changes in any case tend to influence the real economy with considerable lags. Thus, exchange rate developments over the past months probably have not been a significant factor affecting the U.S. economic situation and prospects. The influence of such minor exchange rate changes is extremely small, in comparison with the potential overall impact of other factors influencing the trade and current account position.

The October report noted several factors not captured by conventional models which could contribute to sustained reduction of the trade deficit over the long term. Strengthened competitiveness is much broader based than exchange rate calculations show. Intense competitive pressures during the period of dollar strength forced U.S. producers to make fundamental changes resulting in increased efficiency, reduced costs, and improved quality.

Also, direct investment in the United States should contribute to the adjustment process over time, especially in the automotive sector, with Japanese firms in particular expanding U.S.-based output (for export as well as import replacement), product lines and value added. However, the favorable indirect effects of past exchange rate changes on the trade balance resulting from direct investment activity are of a long-term nature. The modest exchange rate movements over the past 6 months have probably not affected these developments.

Finally, most trade models are based on assumptions of no policy changes. The essence of the G-7 coordination process is that policies are regularly reviewed, with an eye to possible changes in light of developments in the underlying fundamentals. The G-7 are committed to implementing the policies necessary to build on the progress that has been achieved.

PART IV: ASIAN NEWLY INDUSTRIALIZED ECONOMIES (NIEs)

Overview

The U.S. merchandise trade deficit with the Asian NIEs -- Korea, Taiwan, Hong Kong, and Singapore -- was $29.2 billion in 1988, 16 percent below 1987. This development reflected decreases in the bilateral deficits with Hong Kong (down 21 percent to $4.6 billion) and Taiwan (down 26 percent to $13 billion). As a share of the total U.S. trade deficit, the trade deficit with the NIEs increased slightly from 22 percent to 23 percent.

However, as noted in the last report, if the imbalance with Taiwan is adjusted to account for $2.5 billion (customs value) in gold Taiwan imported from the United States in the early part of 1988 for the purposes of diversifying official international reserves and reducing the imbalance, then the trade deficit with Taiwan fell by only 11 percent to $15.5 billion.

Under Section 3004 of the 1988 Trade Act, the Secretary of the Treasury is required to "consider whether countries manipulate the rate of exchange between their currency and the U.S. dollar for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade." It was concluded in the October 1988 report that Taiwan and Korea engaged in such "manipulation," within the meaning of the legislation. Pursuant to Section 3004, the Treasury was required to initiate bilateral negotiations with Taiwan and Korea for the purpose of ensuring that these two economies regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and to eliminate the unfair advantage.

Below is a summary of economic and exchange rate developments in Korea and Taiwan and the negotiations which have taken place with them since October. (See Table 5 on U.S. trade with Asian NIEs and currency changes.)

Korea

o Recent Exchange Rate Developments

The October report to the Congress and subsequent initiation of exchange rate negotiations with the Korean authorities stimulated a period of more intense appreciation of the won in late 1988.

- In the fourth quarter of 1988, the Korean authorities allowed nominal appreciation of the won to total 5.1 percent, compared with 2.5 percent and 1.3 percent in the second and third quarters.

- o Most of this fourth quarter movement occurred in October and November, with the pace of appreciation slowing substantially in December.

Cumulative won appreciation in 1988 totalled 15.8 percent. This exceeded the movement against the dollar in 1988 of the currencies of Korea's key trade competitors, Japan and Taiwan. Thus, in 1988, the Korean won began for the first time to lose on a broad basis some of the advantage that it had gained for Korea earlier in the decade, and particularly since 1985.

Despite the won's strengthening in 1988, cumulative won appreciation still lagged behind that of the yen and New Taiwan (NT) dollar in key periods. For example, in the interval from the Plaza Agreement in September 1985 to end-1988, the won appreciated 34 percent against the U.S. dollar, compared with 49 percent for the NT dollar and 83 percent for the yen. Thus, the won maintained an important, albeit diminished, competitive edge.

In 1989, the authorities have generally maintained the slow pace of appreciation that they resumed in early December 1988. Won appreciation in the first quarter of 1989 totalled only 1.8 percent. However, late March and early April saw a brief period of somewhat more rapid movement of the won as the Treasury Department intensified its negotiations with Korea and the deadline approached for this report. Thus, as of mid-April, the won had appreciated 2-1/2 percent in 1989.

- o <u>1988 Bilateral U.S. Trade Deficit with Korea</u>

According to U.S. customs data, the United States bilateral trade deficit with Korea increased 1 percent in 1988 to $9.0 billion, reflecting a 39 percent increase in U.S. exports to Korea and a 19 percent increase in U.S. imports from Korea. This is significantly slower growth than in 1987 when our bilateral trade deficit increased 39 percent (from $6.4 billion to $8.9 billion), based on a 27 percent rise in exports to Korea and a 33 percent rise in imports from Korea.

In the second and third quarters of 1988, the U.S. bilateral deficit with Korea was actually somewhat lower than in the same quarters in 1987. These declines were due primarily to a drop in the rate of growth of U.S. imports from Korea. This, in turn, was largely the result of the temporary impact of labor disturbances in Korea on production and exports. Growth in the bilateral deficit resumed in the fourth quarter of 1988, registering an increase of 5 percent over the fourth quarter of 1987.

o <u>Korean Global Balance of Payments Developments in 1988</u>

Korea's 1988 global trade surplus increased 51 percent to $11.6 billion on a balance of payments basis. Overall, exports grew 15 percent in volume terms, down from 24 percent in 1987. The growth of import volume, however, decreased even more sharply to 10 percent from 22 percent in 1987.

Toys are the only category of Korean exports that declined in value terms in 1988 (by 7 percent). Textiles and footwear -- other labor-intensive products about whose competitiveness the government expresses concern -- managed increases of 22 percent and 25 percent, respectively, despite won appreciation and higher wages. Exports of higher value-added products performed even more strongly: electronics were up 33 percent, iron and steel 35 percent, machinery 51 percent, automobiles 20 percent (despite second quarter labor disturbances), and ships 55 percent.

Korea's 1988 current account surplus increased 44 percent to $14.3 billion, compared with the government's $7 billion target. Thus, for the third consecutive year, the actual current account surplus was more than double the government's initial target for the year. Increases in net services and transfers -- reflecting declining external interest payments, Olympics-related tourism revenues, and transfers from Korean residents abroad -- contributed to the swelling of the current account surplus.

As indicated in Part II above, the magnitude of external imbalances is best judged by presenting the amount as a percentage of GNP. In this context, it is noteworthy that Korea's trade surplus increased from 6.5 percent of GNP in 1987 to 7.4 percent in 1988, while the current account surplus increased from 8.3 percent of GNP in 1987 to 9.1 percent in 1988. In contrast, Japan's 1988 trade surplus was equal to 3.3 percent of its GNP and its current account surplus, 2.8 percent, both having declined from 1987 to 1988.

With the rapid expansion of its current account surplus in 1988, Korea was able to continue reducing its external debt and building its foreign reserves, further strengthening its international position. Gross external debt fell to $31.2 billion (20 percent of GNP) in 1988, compared with $35.6 billion (30 percent of GNP) in 1987 and $46.8 billion (55 percent of GNP) in 1985. In addition, Korea increased its foreign reserves by nearly $9 billion to $12.3 billion in 1988; although equal to about 3 months' imports, this level is not excessive.

o **Domestic Economic Performance**

Korea's economy continued to boom in 1988. Real GNP growth exceeded 12 percent for the third consecutive year, bringing cumulative real GNP growth to 41 percent since end-1985. Domestic demand is strengthening -- due to large nominal wage increases, lower tariffs, and cuts in excise taxes -- but increased real net exports still accounted for nearly 50 percent of real GNP growth.

Unemployment averaged only 2.5 percent in 1988, the lowest annual average in the last three decades. Wages have increased by about 33 percent in the past 2 years. Cumulative productivity gains among production workers totalling about 30 percent in the past 2 years have largely offset the higher wages.

Monetary and price developments are increasingly showing the negative side effects of Korea's external imbalance. Despite tight credit controls and the government's direct efforts to sterilize the liquidity resulting directly from Korea's massive external surpluses, money supply expanded by about 19 percent in 1988. This, together with the large nominal wage increases and emerging capacity constraints, was largely responsible for the jump in inflation from 3 percent in 1987 to 7.2 percent in 1988.

o **Trade Developments in 1989**

Preliminary Korean customs data for the first quarter of 1989 show a substantial decline in Korea's global trade surplus relative to the same period in 1988. These data indicate that the global trade surplus totalled only $95 million in the first quarter of 1989, compared with $1.4 billion in the first quarter of 1988. Moreover, the won value of Korean exports declined by 4 percent in January and by 8 percent in February relative to the same periods in 1988, although in U.S. dollar terms, Korean exports increased by 11 percent and 6 percent, respectively, given the increase in the dollar value of the won in 1988.

For January-February 1989 (the latest period for which U.S. customs data are available), the U.S. bilateral trade deficit with Korea declined 28 percent, compared with the same period in 1988. U.S. exports to Korea increased 29 percent, while imports from Korea declined by 1 percent.

It is likely that Korea's first quarter trade performance reflects a compounding of seasonal factors (the first quarter is traditionally the weakest quarter in the trade account) and other unique influences:

- o Korean exporters accelerated shipments in the fourth quarter of 1988 in anticipation of continued strengthening of the won.

- Korean importers, for their part, delayed clearing goods through customs in anticipation of the January 1, 1989, tariff cuts.
- Together, these factors helped swell the 1988 fourth quarter trade surplus and produce an abnormally low surplus in the first quarter of 1989.
- The increased level of labor disturbances so far this year is also temporarily suppressing Korea's export performance.

These seasonal or temporary factors notwithstanding, the preliminary data for early 1989 probably also reflect the beginning of a reduction in the underlying imbalance -- perhaps a significant reduction. Previous appreciation of the won, coupled with inflation and some trade liberalization, may have begun to contribute to a welcome structural reduction in Korea's external surpluses.

o <u>Evaluation of Recent Developments</u>

The won's appreciation against the U.S. dollar in 1988 was significant and reflected Korea's recognition of the need for the exchange rate to play a role in the adjustment process. The accelerated appreciation of late 1988, after negotiations were initiated, and more recently in the last few weeks, was a welcome response to our concerns. Nevertheless, cumulative won appreciation remains insufficient, judged against the magnitude of Korea's external surpluses in the past 3 years and the much greater appreciation of the currencies of Korea's competitors in the same period.

Korea's exchange rate policy this year appears to be based on the assumption that the trade data for the first quarter of 1989 foreshadow a drastic reduction in Korea's surpluses for the year as a whole. The indications that structural reduction in these surpluses may have begun are both welcome and hopeful. Nevertheless, the data are too preliminary and limited to indicate clearly such a trend, and in our judgment, do not justify the sharp deceleration in the pace of appreciation in most of the period since early December 1988. While some moderation in the pace of appreciation relative to the fourth quarter of 1988 appears understandable in the circumstances, continued appreciation of the won during the period ahead is nonetheless required to reinforce recent trade developments and ensure that the preliminary, first-quarter reduction in Korea's external surplus is, indeed, the first stage in a structural and lasting correction of the imbalance. If final trade data for the period ahead also show significant reductions in Korea's external surplus, the need for further won appreciation would be diminished.

The Treasury Department's negotiations with the Korean authorities since the October report appear to have produced some results. Cumulative exchange rate appreciation, however, remains insufficient and assurances of further appreciation that could be considered sufficient in the circumstances are lacking. In addition, Korea has not provided indications that it intends to move to a market-based system of exchange rate determination over the medium-term. Nor is Korea willing to engage in broader discussions on financial market liberalization. Thus, our judgment is that, within the meaning of Section 3004 of the Omnibus Trade and Competitiveness Act, Korea continues to "manipulate" its currency.

Our negotiations in the coming months will be aimed at obtaining assurances that exchange rate policy during the period ahead will reinforce the direction of recent trade developments. We will also seek to encourage the Korean authorities to dismantle the comprehensive capital and exchange controls that prevent market forces from asserting themselves in exchange rate determination.

Taiwan

Taiwan's external imbalances have undergone further positive adjustment since the last report. This is due, in large part, to the effects of currency appreciation, further reductions in trade barriers, and rising inflation and wages. If all of these elements, particularly further appreciation, continue this year, we would anticipate an additional reduction in Taiwan's current account surplus and its bilateral trade surplus with the United States in 1989.

Taiwan's global current account surplus also decreased by 43 percent in 1988 to $10.2 billion. As a proportion of GNP, this translates into a sizeable decline from 18.4 percent in 1987 to 8.3 percent in 1988. At the same time, Taiwan's overall trade surplus, excluding official gold imports from the United States, fell 26 percent in 1988 to $13.8 billion ($10.9 billion, including U.S. gold).

In the first 3 months of this year, compared with the same period last year, Taiwan's overall trade surplus was lower by 23 percent, excluding U.S. gold, but up 9 percent including U.S. gold. Moreover, domestic demand has replaced exports as the main source of growth for the economy. Real GNP growth was 7.3 percent in 1988, down from 11 percent in 1987.

Large U.S. exports of gold to Taiwan through August 1988 accounted for more than half of the reduction in the U.S. bilateral deficit with Taiwan. These exports have ceased and need to be replaced with an even greater value of other sustainable exports if the adjustment process is to be furthered

in 1989. In the last 6 months for which U.S. data are available (September 1988-February 1989), the average monthly trade deficit with Taiwan (excluding U.S. gold exports) has fallen 21 percent from the same period a year ago. Nonetheless, annualizing these data results in a trade deficit larger than last year's, or $13.9 billion. Clearly, this is still an unsustainable imbalance.

The New Taiwan (NT) dollar has strengthened by 49 percent against the U.S. dollar since the Plaza Agreement in September 1985, compared to 83 percent for the yen, 53 percent for the German mark, and 34 percent for the Korean won. However, in 1988 the NT dollar depreciated through October. Since the October report, the exchange rate has appreciated by 6-1/2 percent, mainly in 1989. Such currency appreciation is a positive development. Nonetheless, given the still large trade imbalance and the lack of currency appreciation throughout most of 1988, it appears that a continuation of the recent appreciation is required to advance the adjustment process.

During our recent negotiations with Taiwan (under the auspices of the American Institute in Taiwan and Coordination Council for North American Affairs) regarding its exchange rate policy, Taiwan agreed to take a number of important measures, including liberalizing its foreign exchange system and reducing capital controls. This liberalization could represent a potentially important step toward the establishment of a more market-based system of exchange rate determination.

It remains, however, too early to assess fully the effects of these measures. The effectiveness of the liberalization will depend importantly on how it is implemented and, specifically, on satisfactory resolution of uncertainties concerning: the extent of central bank intervention in the market; the continued free flow of trading information; the removal of remaining controls on capital inflows; and the potential for discrimination between Taiwanese and foreign banks. If these potential difficulties are promptly and fully addressed, the liberalization could be a major advance. If not, the new system could regrettably involve little real progress toward exchange rate liberalization.

- <u>Description of New Exchange Rate System</u>

Taiwan began to implement the new exchange rate system on April 3. Formerly, the NT dollar's value against the U.S. dollar was determined by the "middle rate" of interbank transaction rates on the previous business day, with a limit on fluctuation. The most important aspect of the new system is that all NT dollar-U.S. dollar transactions of $30,000 and above will now be freely determined. The exchange rate for small retail transactions under $30,000 will be determined by rotating

groups of nine foreign exchange banks (including foreign banks) based on the prevailing free market rates. Banks can then decide the exchange rate for small transactions based on this "reference rate." If the transacted rates fluctuate in excess of a certain level, then a new "reference rate" is determined with a wider band.

Given that the central bank could still intervene in the foreign exchange market through proxy state-owned banks, a significant reduction of central bank direct and indirect intervention will be essential to allow adequate scope for market forces. However, as announced and initially implemented, the new system does not permit openly ascertaining the level of official intervention. The Central Bank is using five local banks for intervention and information regarding transaction amounts and transaction banks will no longer necessarily be made available as it was in the past. Although the need for some discretion by the Central Bank is understandable, given the relatively small size of Taiwan's foreign exchange market, it need not have come at the expense of a normal degree of transparency for the system.

There are other operational problems with the new system. First, limits have been retained on banks "short" foreign exchange positions. Moreover, additional new limits were imposed on "long" foreign exchange positions. Initially these limits discriminated against foreign banks. Moreover, although foreign banks are to participate in the committee that determines the "reference" exchange rate, this has not yet appeared to be the case. We have indications that Taiwan intends to correct these problems, and will monitor the situation.

We are encouraged by the new foreign exchange system, which could potentially limit intervention. But, as noted above, its significance depends on its implementation. While we also welcome the appreciation of the NT dollar since the beginning of our negotiations, this appreciation, if not continued, will be insufficient against the backdrop of the lack of appreciation throughout most of 1988, which impeded the adjustment process. Therefore, further appreciation, of a sufficient magnitude, will be necessary this year.

Therefore, at this time, we are not yet able to alter our basic judgment that Taiwan, within the meaning of the legislation, "manipulates" its exchange rate. With full implementation of the new system, however, and further adequate exchange rate appreciation, it would be possible to review our position on this matter. Our negotiations in the period ahead will be aimed at prompt resolution of the problems that could limit the effectiveness of the new system as well as obtaining further sufficient appreciation of the NT dollar. It is important that Taiwan's currency more accurately reflect market forces and its external surpluses.

PART V: CONCLUSION

This report has provided an update of developments since October 1988, when the first report on international economic and exchange rate policies was submitted to the Congress.

Global economic performance has remained favorable in the intervening period. The economic expansion is continuing in the major countries, with the seventh year of consecutive growth following an extremely robust performance in 1988. Furthermore, in 1988, the lagged effects of exchange rate changes in 1986 and 1987 and the composition of demand in the major countries were conducive to significant reductions in external imbalances.

The pace of external adjustment has slowed, however. In view of recent developments, including higher oil prices and other factors, improvements in the U.S. trade deficit for 1989 which had earlier been expected may be partly offset. While inflationary pressures bear close watching, there is little concern that a general acceleration of inflation is developing.

The economic policy coordination process has contributed importantly to the improved performance of the global economy in the current expansion. Sustained noninflationary growth remains the central objective of the coordination process and will require continued efforts in reducing fiscal deficits, controlling inflation and gradually reducing external imbalances. In the United States, the recent bipartisan budget framework agreement between the President and the joint leadership of the Congress represents an important step forward in these efforts.

During the past 6 months, exchange markets have been generally stable. The dollar has appreciated slightly against some major currencies, but has been broadly stable on a trade weighted basis. These exchange market developments have, at most, had only a marginal impact on U.S. trade performance and would not be sufficient to change the outlook. The relative stability of exchange rates has made a welcome contribution to, and been supported by, the progress in sustaining global expansion and reducing external imbalances. The G-7 major industrial countries have agreed that a rise of the dollar which undermined adjustment efforts, or an excessive decline, would be counterproductive, and they have reiterated their commitment to cooperate closely on exchange markets.

In the October report, it was determined that Taiwan and Korea, within the meaning of the Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, were "manipulating" their exchange rates against the U.S. dollar to prevent effective

balance of payments adjustment or gain unfair competitive advantage in international trade. In accordance with that section, the Treasury initiated bilateral negotiations with Korea and Taiwan for the purpose of ensuring that they regularly and promptly adjust the rate of exchange between their currencies and the U.S. dollar to permit effective balance of payments adjustment and eliminate the unfair trade advantage.

The appreciation of the Korean won since 1988 has been significant, and coupled with inflation and some trade liberalization, may have begun to contribute to a welcome structural reduction in Korea's external surpluses. Cumulative appreciation of the won, however, remains insufficient in view of Korea's overall economic performance and the large gap that exists between the appreciation of the won and that of the currencies of its major competitors. Korean authorities have slowed the won's rate of appreciation so far this year on the belief that first quarter trade data for 1989, showing a substantial decline in Korea's global trade surplus, portend a drastic reduction for the year as a whole.

In our judgment, these trade data are too limited and preliminary to indicate a clear irreversible trend towards a structural reduction in Korea's surpluses. Although, the Treasury Department's bilateral negotiations with Korea have produced some results, assurances of further adequate exchange rate appreciation are lacking. Moreover, Korea shows virtually no willingness to move to a market-based system of exchange rate determination over the medium-term nor to engage in broader discussions on financial market liberalization. Thus, within the meaning of the legislation, Korea continues to "manipulate" the won. Continued bilateral negotiations with Korea in the period ahead will be aimed at assuring adequate exchange rate cooperation in the near-term. Also, Korean authorities will be encouraged over the medium term to dismantle the comprehensive capital and exchange controls that prevent market forces from asserting themselves in exchange rate determination.

Taiwan's bilateral trade surplus with the United States and global current account surplus have declined. The NT dollar depreciated in 1988 through October, but has since appreciated somewhat. While this appreciation is welcome, further appreciation of a sufficient magnitude is required to advance the adjustment process, given the continued large trade surpluses and the lack of appreciation throughout most of 1988.

Taiwan's new foreign exchange system is an encouraging development, which could potentially limit intervention. The significance of the new system will, however, depend on its full implementation, and uncertainties exist as to the prospects for continued heavy central bank intervention to limit appreciation. Therefore, the basic judgment cannot yet be altered that Taiwan, within the meaning of the legislation, "manipulates" its

exchange rate. With full implementation of the new system and further sufficient exchange rate appreciation, we may well be in a position to review this judgment. Negotiations in the period ahead will aim at prompt resolution of the problems that could limit the effectiveness of the new system as well as obtaining further sufficient appreciation of the NT dollar.

APPENDIX

TABLES

1. Economic Performance of Key Industrial Countries

2. Summary of U.S. Current Account

3. Summary of U.S. Capital Account Flows

4. Measurements of Dollar Movements Versus G-7 Currencies

5. U.S. Trade with Asian NIEs and Currency Changes

Table 1

Economic Performance of
Key Industrial Countries 1/

	GNP Growth 2/		Domestic Demand Growth 2/	
	1987	1988	1987	1988
U.S.	3.4	3.9	3.0	3.0
Japan	4.5	5.7	5.2	7.7
Germany	1.8	3.4	3.1	3.7
France	2.3	3.4	3.4	3.7
U.K.	4.3	4.4	4.3	6.2
Italy	3.1	3.7	4.6	4.1
Canada	4.0	4.2	4.7	5.1
G-7 3/	3.4	4.2	3.7	4.4

	Inflation 4/		Current Account 5/	
	1987	1988	1987	1988
U.S.	3.6	4.1	-3.4	-2.8
Japan	0.1	0.7	3.6	2.8
Germany	0.2	1.2	4.0	4.0
France	3.3	2.7	-0.5	-0.4
U.K.	4.1	4.9	-0.6	-3.1
Italy	4.7	5.0	-0.1	-0.5
Canada	4.4	4.0	-1.9	-1.5
G-7 3/	2.8	3.1		

1/ All data are latest IMF figures, except for U.S.

2/ Real growth rates, annual average.

3/ Average of individual country rates weighted by GNP in dollar terms; annual averages.

4/ Consumer prices; annual averages.

5/ Calculated as percent of GNP; negative indicates deficit.

Table 2

SUMMARY OF U.S. CURRENT ACCOUNT
(MILLIONS OF DOLLARS, S.A.)

	Quarters								Annual		
	87:1	87:2	87:3	87:4	88:1	88:2	88:3	88:4	1986	1987	1988
Total Exports	56791	59864	64902	68014	75140	79443	81674	83648	223969	249570	319905
Agricultural	6486	7118	8287	7626	8910	9547	10213	9598	27357	29516	38268
NonAgricultural	50306	52746	56615	60387	66230	69896	71461	74050	196612	220054	281637
Total Imports	96662	99416	104567	109205	110327	109595	110844	115664	368516	409850	446430
Petroleum	8760	10075	12759	11288	9960	10257	9838	9236	34391	42883	39291
Non-Petroleum	87902	89341	91807	97917	100367	99337	101006	106429	334125	366967	407139
TRADE BALANCE	-39871	-39553	-39665	-41191	-35187	-30152	-29170	-32016	-144547	-160280	-126525
Partial Bal (Excl. Ag Exps & Pet imps	-37597	-36596	-35192	-37529	-34138	-29441	-29545	-32379	-137513	-146914	-125503
Net Services	5214	1825	678	12042	1336	-885	-222	4548	21027	19759	4777
Invest. Income	5076	1692	1067	12539	1128	-1986	-1234	4694	23143	20374	2602
Other Services	138	133	-389	-497	208	1101	1012	-146	-2116	-615	2175
Total Transfers	-2967	-3125	-2980	-4373	-3147	-2777	-3215	-4444	-15309	-13445	-13583
Remits & Pension	-867	-884	-855	-828	-908	-819	-872	-932	-3571	-3434	-3531
Govt Grants	-2100	-2241	-2125	-3545	-2239	-1958	-2343	-3512	-11738	-10011	-10052
NET INVISIBLES	2247	-1300	-2302	7669	-1811	-3662	-3437	104	5718	6314	-8806
CURRENT ACCOUNT	-37624	-40853	-41967	-33522	-36998	-33814	-32607	-31912	-138829	-153966	-135331

Source: Survey of Current Business

Table 3

SUMMARY OF U.S. CAPITAL ACCOUNT FLOWS
(MILLIONS OF DOLLARS, S.A.)

	Quarters								Annual		
	87:1	87:2	87:3	87:4	88:1	88:2	88:3	88:4	1986	1987	1988
US Reserve Assets	1956	3419	32	3741	1503	39	-7380	2272	313	9148	-3566
(Incr(-)Decr(+))											
Other Govt Assets	67	-170	252	1012	-814	-801	1990	3266	-1999	1161	3641
Foreign Official Assets	13977	10332	611	20047	24670	5946	-2534	10930	35507	44967	39012
Industrial	16561	17533	-926	16063	20814	6839	-3314	5557	29379	49231	29896
OPEC	-2801	-2681	-1723	-2750	-1375	-1783	-466	715	-9327	-9955	-2909
Other	217	-4520	3260	6734	5231	890	1246	4658	15455	5691	12025
Banks, net:	15770	-4461	29634	6304	-125	17847	1394	2268	19808	47247	21384
Claims	21870	-22422	-16519	-23460	17108	-13274	-27832	-33495	-59975	-40531	-57493
Liabilities	-6100	17961	46153	29764	-17233	31121	29226	35763	79783	87778	78877
Securities, net	13908	13479	9012	-6238	4799	16783	9806	7985	70481	30161	39373
Foreign Securities	-1639	-88	-972	-1757	-4467	1529	-1554	-2982	-4297	-4456	-7474
U.S. Treasury Securities	-2826	-2431	-2835	496	6887	5457	3412	4130	3809	-7596	19886
Other U.S. Securities	18373	15998	12819	-4977	2379	9797	7948	6837	70969	42213	26961
U.S. Direct Invest. abroad	-10691	-6220	-7870	-19676	-6509	511	-5196	-9241	-27811	-44457	-20435
Reinvested Earnings	-8663	-4932	-6300	-15776	-3636	-1525	-5519	-8749	-19708	-35671	-19429
Equity & Inter-co. Debt	-2028	-1288	-1570	-3900	-2873	2036	323	-492	-8103	-8786	-1006
For. Direct Invest. in U.S.	7979	7229	15026	11742	7347	13061	8395	13420	34091	41976	42223
Reinvested Earnings	1645	736	2081	-1925	3345	1093	1882	852	-2294	2537	7172
Equity & Inter-co. Debt	6334	6493	12945	13667	4002	11968	6513	12568	36385	39439	35051
Other U.S.-Corp., net	1205	4173	-331	248	1700	-6948	2399	n.a.	-7126	5295	-2849
Claims	-491	2603	-215	1248	-315	-7061	749	n.a.	-4220	3145	-6627
Liabilities	1696	1570	-116	-1000	2015	113	1650	n.a.	-2906	2150	3778
NET CAPITAL FLOWS	44171	27781	46366	17180	32571	46438	8874	30900	123264	135498	118783
Statistical Disc.	-6547	13071	-4399	16342	4428	-12624	23733	1013	15565	18467	16550
TOTAL *	37624	40852	41967	33522	36999	33814	32607	31913	138829	153965	135333

Source: Survey of Current Business

Table 4

Measurements of Dollar Movements
Versus G-7 Currencies Since Key Dates
Percent dollar appreciation (+) or depreciation (-)

as of April 12, 1988

Value of the dollar in terms of:	Since Floating Began 3/20/73 to date	Since Dollar Peak 2/26/85 to date	Since Previous Report 10/14/88 to date
Japanese yen	-49.6	-49.2	+4.0%
German mark	-33.2	-45.7	+3.5%
Sterling	+45.8	-38.3	+3.3%
French franc	+40.8	-40.0	+2.4%
Canadian dollar	+19.2	-15.3	-1.5%
Italian lira	+144.3	-36.3	+1.8%

Source: London midday rates.

Table 5

U.S. TRADE WITH ASIAN NIES AND CURRENCY CHANGES

U.S. Trade Deficit with Asian NIEs [1]
(U.S. $ Billions)

	1980[2]	1987[2]	1988[2]	%Change[3]
Hong Kong	-2.1	-5.8	-4.6	121%
Korea	0.2	-9.4	-9.5	n.a.
Singapore	1.1	-2.1	-2.2	n.a.
Taiwan	-2.8	-17.5	-13.0	369%
TOTAL NIEs	-3.6	-34.8	-29.2	722%
Total U.S.	-25.5	-160.3	-126.5	397%
% Total U.S.	14%	22%	23%	

[1] Totals may not equal sum of components due to rounding.
[2] U.S. balance of payments adjusted data.
[3] From 1980 to 1988.

Cumulative Change against US$ as of April 11, 1989 [1]

from:	7/22/80	9/20/85	end-87	10/14/88[2]	Rate on 4/11
HK$	-37.88%	0.41%	-0.30%	0.40%	HK$ 7.78
Won	-11.87%	34.01%	8.70%	6.41%	W 667.5
Singapore$	8.04%	12.49%	1.92%	3.28%	S$ 1.96
NT$	32.72%	49.39%	5.26%	6.55%	NT$ 27.12
¥	66.02%	82.51%	-6.84%	-4.72%	¥ 132.68
DM	-7.89%	53.07%	-15.32%	-4.30%	DM 1.89

[1] This table is calculated in terms of the movement of the foreign currency against the U.S. dollar, as this is the way the Asian NIEs measure their foreign currency movements. Thus, foreign currency appreciation is represented by a (+) and depreciation by a (-).
[2] Date of last foreign exchange report to Congress.