

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 an annual report each October 15 on international economic policy, including exchange rate policy. In addition, Section 3005 requires that the Secretary shall provide a written update of developments six months after the initial report. Annual reports, pursuant to Section 3005, have been submitted in 1988, 1989, and 1990. Written updates of developments have been submitted in April of 1989 and 1990. This is the third update of developments to be submitted to Congress.

Part II of this report reviews the economic situation in the industrial countries. Part III analyzes developments in the foreign exchange markets, including the dollar's movement relative to the currencies of major trading partners and U.S. foreign exchange market intervention. Part IV examines the U.S. balance of payments situation and Part V reviews efforts by the major industrial countries to coordinate economic policies. Part VI provides a status report on developments in the Asian newly industrialized economies and China. The final part provides conclusions on the principal issues discussed in the report.

PART II: ECONOMIC SITUATION IN THE INDUSTRIAL COUNTRIES

Overview

After eight years of robust expansion, real GNP growth for the seven major industrial countries fell to 2.6 percent in 1990, and will likely fall further to the 1-1.5 percent range in 1991. The slowdown reflects recession in the United States, Canada, and the United Kingdom and decelerating growth in Japan, Germany, and elsewhere. On the bright side, industrial country inflation is likely to drop significantly in 1991, and external imbalances are expected to continue to be reduced.

Aggregate real GNP growth in the seven largest (Summit) countries slowed considerably to 2.6 percent in 1990, down from 3.3 percent in 1989 and 4.6 percent in 1988. Thus, 1990 represented the eighth consecutive year of growth in the G-7. The temporary run-up in oil prices and the uncertainties associated with the Gulf crisis contributed, however, to the overall slowdown. For the 24 members of the OECD as a whole, real GNP growth was 2.6 percent, compared to an average annual rate of 3.4 percent during the 1983-90 expansion. (See Table 1 on G-7 economic performance.)

Growth in the United States, Canada, and the United Kingdom slowed sharply over the course of 1990, with each moving into recession by the end of the year. Output growth also slowed, but less dramatically, in France and Italy. In contrast, growth in Germany and Japan accelerated. Thus the growth disparity between the United States and the other industrial countries increased, with U.S. growth of 1.0 percent for the year, and OECD growth outside the United States of 3.5 percent in aggregate. This differential contributed to the further reduction in the U.S. trade and current account deficits.

Inflation in the OECD countries was somewhat higher in aggregate terms in 1990 than it was in 1989, owing mainly to the temporary runup in world petroleum prices late last year. In addition, a number of factors, which affected consumer price indices but did not boost the underlying rate of inflation, temporarily raised recorded inflation. These factors included the temporary effects of bad weather on some crops, the introduction or increasing of consumption taxes, and higher mortgage interest rates (with a high weight in the Retail Price Index) in the United Kingdom.

Taking all these forces into account, consumer prices rose 6.3 percent on a weighted average basis in the OECD countries in 1990, compared to 5.8 percent in 1989. Turkey, Iceland, and Greece had the highest inflation rates. Inflation in the Summit countries alone was 5 percent (vs. 4.5 percent in 1989).

Among the G-7 (Summit) countries, the United Kingdom recorded the highest 1990 inflation rate (9.5 percent). This rate was particularly affected by special factors such as the introduction of the community charge (poll tax). Inflation rates in Italy (6.5 percent) and the United States (5.3 percent) also exceeded the Summit country average for the year. The lowest rates were recorded in Germany (2.7 percent) and Japan (3.1 percent). The rise of many currencies against the dollar during 1990 helped to limit the impact of higher world oil prices (denominated in dollars) on their domestic prices.

Trade and current account developments in 1990 were quite favorable for the goal of reducing external imbalances. The U.S. trade deficit fell once again, despite an \$11 billion increase in petroleum imports (mainly from higher oil prices, but also from an increase in the volume of oil imported). The deficit dropped to \$108.7 billion on a balance of payments basis, down \$6 billion from 1989. The U.S. current account deficit fell to \$99.3 billion, the lowest level since 1984. The current account deficit was equal to 1.8 percent of GNP, one half the 1987 peak of 3.6 percent of GNP (\$162.3 billion).

Japan's external surpluses also fell, with the current account surplus declining from \$57 billion in 1989 to \$35.8 billion in 1990. This \$21 billion reduction -- about \$6 billion of which was attributable to higher oil prices -- brought Japan's current account surplus down to 1.2 percent of GNP from the 1987 peak of 3.6 percent of GNP (\$87 billion).

Germany's current account surplus fell to \$44.5 billion (2.7 percent of GNP), after a peak of \$55.3 billion (4.6 percent of GNP) in 1989. While higher oil prices played a role, the principal factor was strong demand for imports (both in the west, where real total domestic demand grew 5.1 percent last year; and in the eastern states, as one effect of reunification). Germany's \$50.3 billion trade surplus with its EC trading partners fell by a third, after tripling between 1985 and 1989.

Current account deficits for both the United Kingdom and Canada remained sizeable (2.4 percent) in relation to GDP last year. But the United Kingdom's deficit fell by \$8 billion, to \$22.8 billion, as the economy moved into recession. Canada's deficit was little changed in dollar terms, at \$13.7 billion. France and Italy again recorded deficits of moderate size.

The year 1991 is likely to record very low aggregate real GNP growth in the industrial countries -- perhaps in the 1 to 1.5 percent range. A significant slowdown in growth is projected in Germany and Japan. Growth is also projected to be lower in the major continental European countries. The slow average growth projection for the year also reflects recession in the United States, Canada and the United Kingdom in the early months of 1991.

While there are some encouraging signs of prospective economic recovery, the global outlook contains substantial risks, given the persistence of high real rates which generate uncertainties about the strength and timing of increased growth. For example, real short term interest rates in 1990 were 4.5 percent and 5.8 percent in Japan and Germany, respectively, compared to 2.4 percent in the United States.

Inflation prospects for the G-7 countries in aggregate, on the other hand, are favorable. With the passing of last fall's temporary rise in world petroleum prices, slower growth encouraging price and wage moderation, and some special statistical factors in consumer price indices no longer present, inflation rates are expected to decline this year. On a year average basis the decline is likely to be small, but average G-7 inflation is expected by the IMF to fall from 5.5 percent in the year to the fourth quarter of 1990 to about 4 percent in the year to the fourth quarter of 1991.

A further decline in current account imbalances is in prospect for this year. Slower growth in the U.S. will hold down import levels, while the more moderate slowdown abroad will help sustain U.S. exports. There will also be a large temporary reduction in the U.S. deficit as transfers are received from foreign governments in connection with international cooperation in the Persian Gulf. (The effect of these transfers on the balance of payments depends in part on whether they are received in cash or in kind -- only the former would be recorded in the current account.) The current account surpluses of Japan and Germany are also likely to fall, the latter by a considerable margin as imports by the eastern states continue to rise.

PART III: DEVELOPMENTS IN FOREIGN EXCHANGE MARKETS

Overview

Since the October 1990 report, the dollar has appreciated 5.2 percent against the yen and 9.8 percent against the deutschemark. Continental European currencies followed the movement of the dollar versus the deutschemark. The Canadian dollar, the currency of the United States' largest trading partner, remained roughly unchanged against the dollar. (See Table 2.)

On a real, trade-weighted basis, measured against the currencies of 40 developed and developing country trading partners, the dollar's March 1991 value was 4 percent above its October 1990 level. Measured on this basis, the dollar was about at the same level as in early 1980, prior to the 1980-84 appreciation. (See Chart.)

Demand for the dollar increased somewhat in the last quarter of 1990 as a hedge against uncertainty about the Gulf crisis and the Soviet Union. A brief shift out of the dollar occurred in mid-January to mid-February due to movements in interest rate differentials against the dollar and as the favorable conduct of the Gulf War dampened safe haven demands for the dollar. However, market confidence in the dollar returned in the wake of the quick conclusion of the Gulf War, optimism about the outlook for the U.S. recovery, and selling pressures on the deutschemark.

Late 1990

During the final quarter of 1990 and into early January 1991, the dollar drifted upward, boosted by occasional surges in demand for dollar liquidity prompted by market concerns over the risk of war in the Gulf and instability in the Soviet Union. The upward trend was tempered, however, by the slowdown in U.S. economic activity compared to that abroad, and the risk of adverse economic effects from a prolonged Gulf war. Moreover, short-term interest differentials moved further against the dollar during this period, particularly between the United States and Germany. Divergent movements in interest rates resulted in a differential of more than a percentage point between rates for U.S. and German short-term (3-month) assets.

On balance, events in the Gulf at times prompted dollar demand. But as concerns over economic fundamentals reasserted themselves among participants, the lower returns on dollar assets began to depress demand for dollars.

Mid-January to Mid-February 1991

From mid-January to mid-February, the dollar came under selling pressure as it appeared that the Gulf war would not generate sustained safe haven demand for dollars, but might act to depress economic activity. Interest rate differentials unfavorable to the dollar widened further as many believed that the land phase of the war would be lengthy and act as a substantial drag on the U.S. economy.

With military action underway in the Gulf, the G-7 Finance Ministers and Central Bank Governors agreed at their January 21 meeting to strengthen cooperation and to monitor developments in exchange markets. The Ministers and Governors stated that they were "prepared to respond as appropriate to maintain stability in international financial markets." This statement and subsequent intervention to support the dollar reassured the market concerning the G-7 commitment to cooperative action.

The downward pressure on the dollar continued, however, particularly against the deutschemark. The Bundesbank raised official German interest rates on January 31 (a move not generally anticipated in the market) and the Federal Reserve lowered official U.S. interest rates on February 1. Shortly thereafter, U.S. monetary and economic officials voiced dissatisfaction with the dollar's depreciation and optimism about the prospects for economic recovery. A brief episode of concerted dollar purchases by G-7 monetary authorities was also initiated at that time which provided significant support to the dollar.

These official interest rate actions, in retrospect, may have marked a turning point in the foreign exchange markets, with a shift in market psychology in favor of the dollar. This was influenced by an increasingly critical market view of developments in the German economy, Eastern Europe and the Soviet Union.

Mid-February through Mid-April 1991

With the end of the war, market optimism about U.S. economic prospects increased and a period of sustained and rapid appreciation of the dollar began. The dollar rose at times in March as many market participants decided that the dollar had "bottomed out". Moreover, participants focussed on the German mark, which was influenced by concerns over developments in the Soviet Union, East Europe, and the reunification of eastern Germany. Corporate treasurers and institutional investment managers made previously deferred dollar purchases. At this time, U.S. monetary authorities intervened out of concern about the rapidity of the dollar's rise.

Demand for dollars during this period was reinforced as the view took hold that the U.S. economy would likely begin its recovery around mid-year. There was still a note of caution, however, in that market participants expected the recovery to be moderate. Also, many participants believed that the U.S. monetary authorities would view a further rapid rise of the dollar with some concern, given the potential risks to U.S. trade competitiveness.

A major factor in the strength of the dollar during this period was a slackening of demand for deutschemark assets. While many had expected German reunification to produce rapid growth of investment in east Germany, the productive capacity and investment appeal of east Germany proved weaker than initially expected. The market regarded the tax increases in Germany -- announced early in the year -- as an admission by the German government that it had underestimated the cost of integrating west and east Germany.

In addition, demand for German assets declined in light of deteriorating political and economic conditions in the USSR. Many participants were concerned about Germany's ability to cope with both the costs of unification and the possibility of large-scale immigration into Germany from the Soviet Union.

PART IV: U.S. BALANCE OF PAYMENTSDevelopments in 1990

The U.S. trade deficit continued to decline gradually in 1990, to \$109 billion from \$115 in 1989 (balance of payments basis). This represents a decline of \$51 billion, or nearly one-third, from the peak deficit of \$160 billion in 1987. (See Tables 3 and 4.)

Total 1990 exports, at over \$389 billion, were up nearly \$29 billion or 8 percent (9 percent in volume) from their 1989 level. Export growth, though still robust, slowed substantially from the double-digit rates of 1988 (28 percent in value terms; 24.5 percent in volume) and 1989 (12.5 percent and 11.4 percent, respectively). However, a major portion of the extremely rapid export increases during 1988-89 constituted "catch-up" of market share lost during the earlier period of extreme dollar strength. More recently, sustaining U.S. export growth has involved the challenging task of increasing market share beyond previous peak levels. In this light, the continued growth of U.S. exports at rates well above the growth of major markets abroad has confirmed that the competitiveness of U.S. products remains strong.

As in 1989, roughly one-half of the increase in 1990 exports was accounted for by capital goods. Consumer goods and industrial supplies and materials each contributed about one-quarter of the increase; other categories showed little change year-over-year. On a geographic basis, nearly one-half of the increased exports went to Europe, with the remainder spread across other geographic areas. Robust demand growth, and sustained U.S. export competitiveness, led to double-digit growth in the value of exports to Europe, registering a 13 percent increase compared with a 6 percent increase to all other areas.

Imports for 1990 were \$498 billion, up \$23 billion, less than 5 percent in value terms, from their 1989 level. Half the increase was in oil imports, partly though not entirely due to a sharp run-up in oil prices late in the year, related to the Gulf crisis. The remainder was in imports of capital and consumer goods. Imports from Japan and the Asian NIEs actually declined slightly, with the bulk of the increase in imports coming in trade with OPEC. Continued moderation in import growth will be an essential element in further trade deficit reduction.

Reflecting these import and export developments by product and area, the trade balance vis-a-vis Western Europe switched from a \$4 billion deficit in 1989 to a modest surplus of over \$2 billion in 1990. The balance vis-a-vis Japan and the Asian NIEs -- though remaining in deficit -- also improved, although about one-half of the improvement reflected lower U.S. imports rather than export gains, as was the case for the balance with Western Europe.

The 1990 current account deficit, at \$99 billion, was under \$100 billion for the first time since 1984. Roughly one-half (\$6 billion) of the \$11 billion improvement from 1989's \$110 billion deficit reflected the trade balance improvement, discussed above. The remaining \$5 billion came from an increase in the net inflow for all other components of the current account combined: investment income, services, and transfers.

The increase in net investment income was extremely large, over \$8 billion. In large part, this reflected a decline in U.S. earnings of foreign direct investors, which, in turn, was related to the more moderate pace of activity in the U.S. economy. Net receipts on services other than investment income registered a modest increase of over \$2 billion, continuing the gradual upward trend of recent years. Offsetting these increased inflows was an increase in the net outflow for unilateral transfers of over \$6 billion, principally reflecting forgiveness of debt owed by Egypt. (The impact of the grant to Egypt was partly offset by receipts of cash support from coalition partners for Operation Desert Shield.)

Financing of the 1990 current account is obscured by the extremely large (\$73 billion) statistical discrepancy, which is thought generally to reflect unrecorded capital flows. The recorded inflow of capital from net investments by private foreigners was exceeded by the recorded outflow of investments abroad by U.S. investors. Aside from the statistical discrepancy, the other source of net capital inflows was an increase in foreign official holdings of U.S. assets.

Prospects for 1991

The prospect for 1991 is for a substantial further decline in the trade deficit. The current account should show a similar underlying trend, but, in addition, contributions by allies in support of Operation Desert Storm will give a one-time, dramatic increase in invisible receipts producing a very large one-time decline in the current account deficit in 1991.

Exports should continue to show steady growth, similar to the 1990 performance. The U.S. competitive position remains solid: despite recent dollar fluctuation, on a trade-weighted basis against a basket of currencies, it remains within the ± 10 percent or so band observed since its 50 percent decline in 1985-87. In addition, growth in markets abroad remains solid, although there are emerging concerns that growth in Europe and Japan may slacken over the course of this year.

Non-oil import growth in 1991 should remain low, though it should pick up somewhat during the course of the year from the very low 3 percent value growth for 1990 as part of the normal part of a cyclical recovery. The value of oil imports is likely to decline in 1991, reflecting lower average oil prices. While the volume of oil imports may rise, as depleted stocks are rebuilt in the early part of the year and demand picks up in the latter part of the year, the oil price decline is likely to be larger than the volume increase.

These trends point to a 1991 trade deficit in the \$90 billion range, below \$100 billion for the first time since 1983. In addition, further underlying progress is being made in reducing the current account deficit. Thus, the current account deficit may fall to around \$75 billion, excluding the one-time impact of Desert Storm contributions. Including these contributions, the current account deficit could even be below \$40 billion.

PART V: ECONOMIC POLICY COORDINATION

The world economy has become increasingly interdependent in recent years and, more and more, economic power and responsibility are shared in view of the greater balance among nations. The linkages among major economies are being heightened by the globalization of flows of goods, services, and investment. Financial markets involve around-the-clock trading. Against this background, countries continue to pursue their own self interests. But they increasingly recognize that they must work collectively to achieve their shared objectives.

The pursuit of international economic policy coordination in the G-7 has become essential for achieving these shared objectives. Indeed, over the years, the G-7 have made significant progress in implementing consistent policies for sustained growth with price stability, reduced external imbalances, and greater stability of exchange markets. Furthermore, economic policy coordination has been extended to a wide range of international economic policy issues. Thus, the G-7 have in recent years addressed such issues as cooperation in the Persian Gulf, the transformation of Eastern European economies, and the international debt strategy, as well as a range of other international financial issues concerning individual countries and the international financial institutions.

The meeting of the G-7 Finance Ministers and Governors on January 20-21, 1991, reflected this reality. The Ministers and Governors met against the background of the Gulf war, reaffirming their support for economic policy coordination and agreeing to strengthen cooperation to maintain stability, as appropriate, in international financial markets in light of the uncertainties arising from the Gulf war and developments then taking place in the Soviet Union.

More recently, the G-7 Ministers and Governors met on April 28, in the context of an economic environment that had substantially changed during the preceding months. Several major economies were experiencing recession. Economic activity was slowing in other industrial countries, including those which had been experiencing strong expansion. Indeed, the IMF had marked down significantly its projection for G-7 growth in 1991 to 1-1/4 percent, a full percentage point lower than the October 1990 projection.

Furthermore, other important changes in the world economy with significant medium-term implications have been occurring. In this context, the Ministers and Governors welcomed the critical reform efforts underway in Eastern Europe, Latin America, and other developing countries, and agreed that a strong global economic recovery and open markets in the major industrial countries will provide necessary support for these efforts.

At their meeting, the G-7 noted the hopeful signs of recovery in some quarters. In particular, there were indications of a prospective economic recovery and lower inflation in those countries which were in recession. Adjustment of structural fiscal deficits was underway in the United States and a number of other countries which would strengthen public savings. External imbalances have been further reduced. Interest rates in the United States, in particular, have declined.

But a recovery of world economic activity is by no means certain. High real interest rates persist in many countries, dampening investment and growth prospects, and economic activity is slowing in those countries which until recently had been experiencing strong expansion.

Fostering an open, growing world economy is the most effective tool to meet the challenges of the world economy. The Ministers and Governors therefore emphasized the importance of monetary and fiscal policies which provide the basis for lower real interest rates and a sustained global economic recovery with price stability. They agreed that such a medium-term strategy was the best way to reduce the potential risks and uncertainties in the current outlook. And they reaffirmed their commitment to cooperate closely on exchange markets. In the period ahead, it will be important to take concrete actions to strengthen prospects for sustained growth with price stability.

PART VI: ASIAN NEWLY INDUSTRIALIZED ECONOMIES
(NIEs) AND CHINA

Overview

Since mid-October 1990, Korea's currency has depreciated some 1.5 percent against the U.S. dollar, while Taiwan's has remained virtually unchanged. Over the longer term, since the Plaza Agreement in September 1985, the NT dollar has strengthened by 48.6 percent and the Korean won by 23.2 percent against the U.S. dollar (see Table 5).

The decline in the U.S. merchandise trade deficit with the Asian NIEs as a group -- Korea, Taiwan, Hong Kong, and Singapore -- continued in 1990. In 1990, the trade deficit with the Asian NIEs was \$19.7 billion, down \$4.6 billion or 19 percent from 1989. This compares to a 7 percent decline in the overall U.S. trade deficit. As a proportion of the overall U.S. trade deficit, the deficit with the NIEs fell from 22 percent to 20 percent between 1989 and 1990. In the first two months of 1991, the trade deficit with the NIEs was \$1.6 billion, 51 percent below the same period of 1990.

At the same time, the U.S. trade deficit with China has risen. In 1990, the trade deficit with China was \$10.4 billion, an increase of 68 percent over 1989. The bilateral trade deficit with China is now our third largest, after Japan and Taiwan.

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 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...on an expedited basis...for the purpose of ensuring that such countries regularly and promptly adjust the rate of exchange between their currencies and the United States dollar."

It was concluded in the October 1988 report that Taiwan and Korea "manipulated" their exchange rates, 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.

In April 1990, the Treasury concluded that Taiwan and Korea were no longer directly "manipulating" their currencies within the meaning of the legislation. This finding was reaffirmed in November 1990. It was noted, however, that particularly Taiwan's external surpluses remained large. In addition, it was noted that in both Taiwan and Korea, exchange rate policy would continue to have an important role to play in furthering their economic adjustment. Furthermore, it was noted that, particularly in Korea, liberalization of remaining exchange and capital controls was required to improve the functioning of the exchange markets and assure full scope for market forces in exchange rate determination.

Our large and growing bilateral trade deficit with China, substantial depreciation of the yuan in 1990, and administrative controls over foreign exchange allocation, have prompted serious concern as to the applicability of Section 3004 to China. This issue will be analyzed below.

Following is a summary of economic and exchange rate developments in Korea, Taiwan, and China.

Korea

The steady depreciation of the Korean won in nominal terms against the U.S. dollar has continued since the last report. The won has depreciated by 1.5 percent since mid-October 1990 and 8 percent since its peak in April 1989. In real terms (i.e., adjusted for U.S.-Korean inflation differentials), however, the won has shown little change against the U.S. dollar over the past year as inflation in Korea has remained high.

The renewed nominal depreciation of the won reflects in part the adjustment in Korea's external accounts, which moved into a modest deficit in 1990. However, the exchange rate also continues to be influenced by pervasive foreign exchange and capital controls in Korea. These controls constrain the forces of supply and demand in the exchange market, distort trade and investment flows, and position the authorities to manipulate the exchange rate through indirect means.

o Exchange Market Developments

Under the "market average rate" (MAR) system of exchange determination, introduced on March 2, 1990, the won/dollar exchange rate at the beginning of each business day is equal to the weighted average of transactions in the inter-bank market on the preceding business day. Inter-bank and customer rates are allowed to float freely within specified margins. Exchange rates between the won and third currencies are set in accordance with dollar rates in international currency markets.

During the first thirteen months of the MAR system (through April 12, 1991), the won depreciated 4.4 percent in nominal terms against the U.S. dollar and 6 to 13 percent against most other G-7 currencies. Foreign banks accounted for a large share of transactions in the inter-bank market, generally 40-60 percent of the total. The Bank of Korea (BOK) was not a direct participant in the market, and other government-owned banks accounted for only a small share of inter-bank activity.

Since the Plaza Agreement in September 1985, the won's cumulative nominal appreciation against the U.S. dollar now stands at 23.2 percent. However, much of that appreciation occurred in 1988 and first quarter of 1989; the won peaked at 665/dollar in April 1989 and has depreciated roughly 8 percent in nominal terms against the dollar since then. The cumulative nominal depreciation against the dollar since the first of these reports was issued in October 1988 now stands at 2.1 percent.

In real effective terms, i.e., taking into account movements of the won against major trading partners as well as relative inflation rates, the picture is somewhat different. On this basis, we estimate that the won appreciated some 11 percent between October 1988 and the middle of 1989. Since that time, the won has steadily depreciated in real effective terms, with the result that its cumulative real effective appreciation since October 1988 now stands at only 2.3 percent.

o Foreign Exchange and Capital Controls

The Korean authorities maintain a comprehensive array of controls on foreign exchange and capital flows. These controls prevent market forces of supply and demand from playing a fully effective role in exchange rate determination, distort trade and investment flows, and provide the Korean authorities with tools for indirectly manipulating the exchange rate.

Foreign exchange banks are required to obtain and review, prior to entering into spot customer foreign exchange transactions, original documentation of an underlying trade (or other) transaction. This requirement makes it virtually impossible for banks to conduct foreign exchange business over the telephone and hampers the development of Korea's foreign exchange market. Other controls severely restrict the use of short-term trade finance, and there are effective limitations on a variety of current account transactions such as travel and remittances. Portfolio investment abroad by Korean individuals is restricted to participation in a limited number of Korean-managed unit trusts. Direct portfolio investment by foreigners in Korea is prohibited, although the Korean Government has announced that a limited, but as yet unidentified, opening of the domestic capital markets will occur sometime in 1992. The government also controls capital flows in connection with foreign direct investment in Korea, as well as investment abroad or foreign borrowing by Korean residents. These and other controls limit the ability of branches and subsidiaries

of foreign companies located in Korea to obtain investment and working capital and even import finance.

o Trade and Economic Developments

Domestic Economy

Korea's real GNP is estimated to have grown 9 percent in 1990, compared with 6.7 percent in 1989 and over 12 percent annually in 1986-88. Growth in 1990 was led by private consumption and fixed investment, with the construction and manufacturing sectors registering particularly strong performances. Inflation is estimated to have reached 8.6 percent in 1990. Unemployment remained low at 2.4 percent. In 1991, the real GNP growth rate is expected to remain strong at about 8 percent. Inflation is a growing concern, with the consumer price index rising at an annualized rate of nearly 20 percent in the first quarter of 1991.

External Accounts

Korea's external accounts have undergone substantial adjustment since 1989 largely because of the substantial real appreciation of the won in 1988-89. Other factors in the adjustment include: the strong growth of the domestic economy (drawing in greater imports); rising wage demands and other factors adversely affecting Korea's export competitiveness; and rising oil import prices and lost export opportunities in the wake of the Persian Gulf crisis.

For the first time since 1985, the current account fell into modest deficit in 1990, by \$2.1 billion (0.9 percent of GNP). This included a trade deficit of \$1.9 billion on a balance of payments basis, compared with a trade surplus of \$4.5 billion in 1989. Merchandise exports were up 4.2 percent in value terms from the previous year, while imports rose 13.6 percent. The current account deficit in the first quarter of 1991 reached \$3.9 billion. However, with exports recovering strongly and import growth slowing, the Bank of Korea projects that the deficit for all of 1991 will narrow to \$2 billion, implying a return to monthly current account surpluses later this year. This in turn suggests that, notwithstanding the Korean Government's earlier projection of a current account deficit in 1992, external surpluses are likely to reemerge from next year.

According to U.S. customs data, the U.S. bilateral trade deficit with Korea in 1990 fell to \$4.1 billion, down 38 percent from 1989. This was based on a 7 percent increase in U.S. exports to Korea and a 6 percent decline in imports from Korea. In the first two months of 1991, the United States ran a small trade surplus of \$13.5 million with Korea.

After declining steadily since 1985, Korea's gross external debt rose to \$31.7 billion by the end of 1990, compared with \$29.4 billion at the end of 1989. The 1990 gross debt figure is equal to only 13.5 percent of GNP, compared with 52 percent of GNP in 1985. Total interest and amortization payments declined from \$8.1 billion in 1989 to \$6.9 billion in 1990. As a ratio of exports of goods and services, debt service declined from 11 percent in 1989 to 9 percent in 1990. Gross official reserves at the end of 1990 totaled \$15 billion, representing 2.8 months of import coverage. With the negative trends in the current account, reserves fell to \$13 billion by the end of March 1991, about the same level as at end-1988, when Korea experienced its peak current account surplus.

Policy Developments

In the last report, we noted with concern that the Korean Government had strengthened its controls over various aspects of the economy during 1990 and postponed earlier plans to deregulate and liberalize. Responding to foreign expressions of concern about the direction of economic policy, senior Korean officials issued a series of public statements in the early part of 1991 affirming the Korean Government's commitment to free trade and calling on government ministries to alleviate economic tensions with other countries.

The Ministry of Finance has taken some concrete measures over the past year to improve the treatment of foreign financial institutions in Korea. These steps include an increase in the ceiling on issuance of certificates of deposit (CDs) by foreign banks in June 1990, elimination of the ceiling on foreign banks' paid-in capital in Korea, and extension of the operating hours of cash dispenser machines.

However, fundamental denials of national treatment for foreign financial institutions in Korea remain. These denials of national treatment manifest themselves in several areas. Notwithstanding the increase in CD limits, U.S. banks report severe and growing difficulties in meeting the local financing needs of their traditional clients. Swap lines, the chief source of local currency for foreign banks, have been cut several times since December 1987 without deep, viable alternative sources of funding being made available. Discrimination against foreign banks in the setting of interest rates in the interbank call money market has not abated. At the same time, the regulatory environment for foreign banks in Korea has been tightened, in a manner that lacks both transparency and consistency.

In the securities area, the Ministry of Finance has imposed stiff criteria for foreign branch establishment, including burdensome and discriminatory minimum capital requirements. These criteria are all the more onerous because the Ministry of Finance has not yet specified the range of permissible activities for

foreign securities branches in Korea when they are allowed to begin operating in 1992.

The Korean Government has also done little to address the need for broader liberalization of its tightly controlled financial markets, including deregulation of interest rates and elimination of credit allocation schemes.

The Department of the Treasury views these issues as evidence that the Korean Government is unwilling in certain important areas to address the fundamental concerns of the United States. We will continue to pursue them with the Korean Ministry of Finance through the bilateral Financial Policy Talks, and the Uruguay Round financial services negotiations.

Assessment

At this time, there is no basis for concluding that Korea is directly "manipulating" its exchange rate, within the meaning of the 1988 Trade Act, for the purposes of competitive gain, or that the Government is using the array of exchange and capital controls at its disposal to "manipulate" the rate indirectly. This assessment is based on the following factors: the reemergence of modest trade and current deficits in 1990, the likelihood that Korea will again post small external deficits in 1991, the decline in Korea's foreign reserves in the first quarter of 1991, the lack of evidence that the Bank of Korea is intervening directly in the exchange market, and the modest role of other government-owned foreign exchange banks in the market.

Nonetheless, we remain seriously concerned that pervasive Korean exchange and capital controls significantly constrain supply and demand in the currency market. The exchange rate determination system in place, while an improvement over the previous regime, is far from a truly market-determined exchange rate system. Liberalization of these controls is imperative to strengthen the role of market forces in exchange rate determination and in trade and investment flows, and would contribute significantly to the prospects for sustaining Korea's recent external adjustment.

Therefore, in the period ahead, the Treasury Department will continue to monitor developments in Korea's external accounts and the operation of the new market-average exchange rate system. In particular, with a return to external surpluses likely in 1992, we would expect to see a renewed trend toward appreciation of the won. We will also continue to press for liberalization of Korea's financial, capital, and exchange markets, as well as to seek improved treatment for U.S. financial institutions in Korea.

Taiwan

Since the October 1990 report, Taiwan's external surpluses have continued to fall, while the NT dollar has fluctuated within a small range. Factors such as the relocation of lower, value-added, export industries overseas; rising wages and production costs; and inflationary pressures have continued to play an important role in the decrease in the external trade surpluses over the past year. The expected slow growth over the near-term in Taiwan's major export markets, particularly the United States, in addition to the above elements, should lead to a further reduction in Taiwan's external surpluses this year. However, Taiwan's current account surplus, in nominal terms and relative to GNP, will still be unsustainably large.

o Exchange Rate Developments

Since the October 1988 report, Taiwan's cumulative exchange rate appreciation against the dollar has been only 6 percent in nominal terms. The NT dollar began 1990 at NT\$26.17/U.S.\$1 and depreciated by less than 1 percent during the first four months of the year. In mid-May 1990, the NT dollar depreciated by 4 percent to NT\$27.40/U.S.\$1 due to substantial net capital outflows caused by political uncertainties and slower economic growth. In June, the Central Bank sold U.S. dollars and imposed severe deposit requirements on foreign exchange accounts, inducing a firming of the NT dollar to NT\$27.20/US\$1. This, along with an improvement in the political situation, led to a reversal in capital flows in the second half of the year. Since mid-1990, the NT dollar has fluctuated within a small range against the U.S. dollar. The NT dollar depreciated against all other major currencies through 1990 as a whole. As of April 12, the exchange rate stood at NT\$27.28/US\$1.

Given the strength of Taiwan's economic fundamentals, the expectation of increased growth, a still large current account surplus, and a more stable political environment, there is every reason to expect strengthening of NT dollar in the months ahead.

o Trade and Economic Developments

Taiwan's global current account surplus decreased by 4.6 percent in 1990 to \$10.9 billion. As a proportion of GNP, this was a fall to 6.7 percent from 7.5 percent in 1989. Taiwan's overall trade surplus (cif basis) was down 10 percent last year from 1989 to \$12.5 billion.

The U.S. trade deficit with Taiwan in 1990 was 14 percent lower than in 1989 at \$11.2 billion. This reflects a 7 percent fall in U.S. imports from Taiwan. However, U.S. exports to Taiwan only increased by 1 percent.

According to Taiwan's data, our bilateral trade imbalance contracted by 24 percent to \$9.1 billion in 1990. Exports to the United States dropped by 9 percent, the steepest decline in 16 years. The U.S. share of Taiwan's exports fell 4 percentage points

to 32 percent. In addition, as a result of Taiwan's efforts to diversify its export markets and the growing demand from Taiwan's offshore industries, Asia replaced North America in 1990 as Taiwan's largest export market for the first time.

In 1990, real GNP growth fell to 5.3 percent from 7.3 percent in 1988 and 1989. The fall was due principally to the decline in private investment, inventories, and the trade surplus. However, given the pick-up in growth beginning in the last quarter of 1990 and strong expansion by the public sector, we expect growth this year to be close to the level of 1988-89. At the same time, inflation officially rose by 4.1 percent last year, although this is probably an understatement. Inflation is unlikely to improve this year.

Taiwan experienced a substantial rise in net capital outflow last year, due largely to sizable increases in overseas investment and short-term flows from NT dollar to foreign currency accounts. As a result, the overall balance of payments surplus plummeted 98 percent to just \$55 million, the lowest level in the past 10 years. Foreign exchange reserves, consequently, were virtually unchanged at \$72.4 billion, the world's second largest stock at the time.

The current account surplus is expected to continue to fall in 1991. This is the result of a lower merchandise trade surplus and increased service payments.

In the first quarter of this year, Taiwan's overall trade surplus fell by 9 percent over last year to \$1.6 billion.

The U.S. trade deficit with Taiwan in the first two months of this year totalled \$1.5 billion, a 12 percent decline from the comparable period in 1990. U.S. exports to Taiwan were up by 8 percent and imports from Taiwan down by 2 percent.

According to Taiwan's data, the trade surplus with the United States was down by 29 percent in the first 3 months of this year, due to a 7 percent decline in exports to the United States and a 5 percent increase in imports. The U.S. share of Taiwan's overall trade surplus fell to 81 percent, compared to 103 percent over the same period in 1990.

o Exchange Rate System

There is no evidence that the Central Bank has recently been intervening in the market consistently to gain competitive advantage. The Central Bank has, however, intervened to control short-term downward and upward pressure on the NT dollar, although not with the same dominance before the institution of the new exchange rate system two years ago. On a net basis, the Central Bank probably sold more U.S. dollars through intervention than it bought in 1990, thereby, favoring appreciation of the NT dollar.

Taiwan continued to take a number of measures to liberalize the system further and reduce capital controls over the past year and since the October 1990 report.

All foreign exchange transactions can now be freely determined, beginning with the announcement at end-1990 that authorized foreign exchange banks are permitted to set their own exchange rate for small foreign exchange transactions (less than \$10,000) that had formerly been fixed by a committee of banks.

The breadth of the foreign exchange call loan market (maturity ranges from overnight to six months) has been expanded in terms of eligible participants and tradable currencies. As such, daily turnover has risen dramatically to approximately \$1.2-1.5 billion. Fifty foreign exchange banks were permitted to participate at the establishment of the call loan market in August 1989. Since August 1990, headquarters and affiliated institutions of foreign banks in Taiwan, overseas branches of local banks, and all financial institutions in Singapore, New York, and London have been allowed to participate in the market. The tradable foreign currencies have been increased from only the U.S. dollar to all other 12 currencies listed on the foreign exchange market. The foreign exchange call loan market also signed a linkage agreement with Singapore early this year, on top of linkages already with Hong Kong, Tokyo, and Seoul.

In addition, the minimum one-month holding period for fixed-term foreign exchange deposits was eliminated in January 1991. The foreign exchange reserve requirement instituted in June 1990 to stem capital outflow was also rescinded in late-November.

The limit on foreign exchange (forex) liabilities of each foreign exchange bank was increased twice in 1990, by 30 percent in March and by 50 percent in August. The aggregate level for all foreign exchange banks was, thereby, raised to \$30 billion. The limit on the short (oversold) position of each foreign exchange bank was doubled to \$6 million in early August. These relaxations should broaden foreign exchange activities and make the NT dollar's value more open to market forces.

The limits on foreign exchange inflows and the amount of cash an individual can carry in and out of Taiwan were relaxed. (The cash maximum was raised 400 percent to a still small NT\$40,000 or \$1466.) The annual limit on non-trade related capital inflows was raised from \$2 million to \$3 million per entity in July. (Capital flows for trade purposes are unlimited.) At the same time, however, the annual limit on capital outflows was tightened from \$5 million to \$3 million, or the same limit for inflows.

The easing of the inflow restriction was, in part, a response to U.S. criticism in previous reports that the uneven limits on inflows and outflows distorted the operation of market forces and constituted a bias against appreciation. In that sense, the change

is welcome. Tightening the limit on outflows, however, was not a positive action, although it was probably instituted out of concern for the large movement of capital overseas in 1990. The Central Bank claims that the lower outflow limit will have little practical effect since over the last three years, the amount of outward remittances averaged only \$26,000, with just 4 cases out of 10,000 exceeding \$3 million. It is our expectation that the Central Bank will raise both limits in tandem as the market continues to be stable and it gains confidence.

The maintenance of restrictions on "long" and "short" foreign exchange positions and the method of calculating the foreign exchange positions of a bank effectively prevent a forward foreign exchange market from functioning. The cash or spot basis Taiwan uses to calculate a bank's foreign exchange position is contrary to normal international practice. Taiwan instituted a cash basis method in 1987 to deter pressure for NT dollar appreciation and to prevent foreign banks from doing forward foreign exchange transactions. That is, on a cash basis, forward foreign exchange positions are not counted. Taiwan should, thus, return to the Generally Accepted Accounting Practice norm of using an "accrual" basis in calculating foreign exchange transactions and allow the operation of a forward market.

The ceilings on foreign exchange positions also discriminate against foreign banks. For example, the limit on forex liabilities varies by bank, depending on the average outstanding balance over a certain period of time. In all likelihood domestic banks were forewarned of changes in the ceiling, allowing them to build up their outstanding balances beforehand. Moreover, the ceiling on overbought forex position is \$50 million per bank for the five large domestic banks and \$20 million per bank for all other banks, including the foreign banks. Finally, the limits on forex positions are based on local assets. The assets of foreign banks, however, are relatively small since Taiwan has restrictions on their operations and branches.

o Assessment

We are encouraged by the fall in Taiwan's external surpluses over the past year and the continued liberalization of the exchange rate system, which now more accurately reflects market forces. We have no evidence of direct exchange rate "manipulation" for unfair competitive purposes. There is still reason to be much concerned, however, about Taiwan's persistently large external surpluses, especially relative to GNP. As such, there is a need for a more rapid decline in these surpluses. Exchange rate appreciation will likely need to play a role in this process. Indeed, with continued strong growth, sizable external surpluses, and greater domestic political stability, a renewed trend toward broad appreciation of the NT dollar would be expected. Limitations on foreign exchange transactions and capital flows, while less pervasive than in Korea's case, remain too restrictive and impede the full operation

of market forces in exchange rate determination. Given Taiwan's advanced state of economic development, such limitations should be significantly relaxed. We will continue, therefore, to monitor carefully the situation and urge the authorities to further liberalize controls on capital and foreign exchange transactions.

China

In the October 1990 report, we noted China's tendency to run global current account and trade deficits since experimentation with economic and trade liberalization began in 1979. At the same time, we observed that China's bilateral trade surpluses with the United States had grown rapidly since 1985. China's exchange rate had been devalued periodically, but apparently not to the extent that the fall in the yuan had matched the pace of increase in Chinese inflation, thereby causing China to lose competitiveness. Since that report, however, there are mounting indications that China may seek to run significant current account and trade surpluses by combining devaluations of the yuan and tight controls over foreign exchange allocation with severe restrictions on imports.

o Exchange Rate System

China officially has a dual exchange rate system. There is an administered ("managed float") exchange rate which applies to transactions under the state trade plan. There is also a "floating" rate determined in the "foreign exchange adjustment (swap) centers" where foreign investment corporations and all domestic entities which are allowed to retain foreign exchange can conduct foreign exchange transactions based on rates agreed by the buyer and seller. This foreign exchange, however, can only be used to purchase "priority" products and transactions must be approved by the State Administration of Exchange Control. The swap centers were instituted in 1986 and have since then grown significantly in number (100) and breadth of transactions. There are also various internal settlement rates used to conduct transactions; for instance, between factories and foreign trade corporations. In addition to the official dual system, there is an active black market for foreign exchange trading.

o Exchange Rate Developments

There has not been a consistent pattern of nominal yuan devaluations against the dollar since the yuan (administered rate) was devalued by 15 percent in 1985 and another 17 percent in 1986. In December 1989, however, the administered rate was devalued in nominal terms by 21 percent to Yuan 4.72/US\$1 due mainly to a desire to reduce state subsidies to exporters who lose money on sales of products with higher domestic production costs than prevailing international prices. This depreciation was instituted in anticipation of eventual import liberalization, which has not,

however, materialized. The PRC then instituted another substantial devaluation (9.6 percent) of the administered exchange rate in late-November 1990, again with the stated purpose of unifying this rate with the swap market rate and lightening the budgetary burden of export subsidies. In addition, in early April, the yuan was devalued by 1 percent without a public announcement.

There are perhaps two interpretations of the latest moves. Firstly, this could be an indication that China will be pursuing a policy of more frequent and smaller changes, particularly devaluations, in the exchange rate to gain competitive advantage in a quieter fashion. Secondly, China could be responding to the advice of the international financial institutions to adjust the exchange rate more flexibly in preparation for convertibility. In either case, there is reason to monitor China's exchange rate movements closely.

China: Exchange Rate and Inflation

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
Exchange Rate (Yuan/\$; end-year)	3.20	3.72	3.72	3.72	4.72	5.22
Nominal Ex. Rate Index (Yuan/\$; end-year)	100	116	116	116	148	163
CPI Index	100	107	116	141	163	167
Real Effective Index (inflation adj., trade weighted; end-year)	100	78	73	87	81	61

From 1985 through 1988, nominal devaluation of the yuan against the dollar was not sufficient to offset the impact of rising prices in China. Thus, in real terms (i.e., adjusted for China-U.S. inflation differentials), the bilateral exchange rate appreciated against the dollar over this period. Since then, however, as noted above, the yuan has depreciated in real terms.

Against the broader range of currencies of China's trading partners, and adjusted for differentials between China's inflation and that of its major trading partners, the picture is somewhat different. On this basis, the yuan has depreciated significantly (see real effective index). Since 1985, the yuan had depreciated by 39 percent in real effective terms. During this period, the real effective exchange rate did appreciate sharply in 1988, but has since fallen again. In 1990 alone, the nominal devaluation in November and lower inflation (3 percent) resulted in a 25 percent effective devaluation.

At the same time, the exchange rates in the swap centers and black market are weaker than the administered rate, typically by 20 percent and 30 percent, respectively. This gap has narrowed recently, however. For example, in early 1991, the exchange rate in the swap centers was close to Yuan 5.7/US\$1, or approximately 9 percent below the value of the administered rate.

Given the large and growing external surplus, the apparent unwillingness to abolish export subsidies fully, and lack of reform of the trade system, there is certainly no justification for further devaluations. At the same time, while an appreciation of the administered official exchange rate could dampen external demand for China's exports, it would probably have little effect on the flow of imports given the number and complexity of other barriers to imports.

o Trade and Economic Developments

China has characteristically had overall trade and current account deficits in recent years. In 1990, however, China's merchandise trade balance moved to a \$9 billion surplus from a deficit of \$5.6 billion in 1989. The current account also went from deficit in 1989 to an estimated \$10.2 billion surplus in 1990, equal to 2.8 percent of GNP. This year, these surpluses are expected to increase by sizable amounts.

China: Current Account and Trade Balance (\$ Bn.)

	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>
Current Account	-11.4	-7.0	0.3	-3.8	-4.3	10.2
% of GNP	-3.9	-2.6	0.1	-1.0	-1.0	2.8
Global Trade Bal.	-13.1	-9.1	-1.7	-5.3	-5.6	9.0
% of GNP	-4.4	-3.2	-0.6	-1.4	-1.2	2.5
Trade Surplus w/U.S. (U.S. data)	0	1.7	2.8	3.5	6.2	10.4
% of GNP	0	0.6	0.9	0.9	1.3	2.9

According to U.S. customs value data, China has a large and growing trade surplus with the United States. China's bilateral trade surplus with the United States grew 67 percent to \$10.4 billion in 1990. This trend stems largely from a significant increase in Chinese exports -- especially clothing, toys, sporting goods, footwear, and consumer electronics -- to the United States. China's export capacity has benefitted greatly from foreign investment, particularly from Hong Kong and Taiwan, as production of labor intensive goods in those economies has become uncompetitive. Before being transferred to China, much of this production was targeted for export to the United States and this is still the case.

In 1990, China's exports to the United States rose by 27 percent, following a 41-percent expansion in 1989. These growth rates are significantly above those for China's global exports during the same period (18 percent in 1990 on top of 7 percent in 1989). (NOTE: There is a major discrepancy between China's calculation of its trade with the United States and U.S. official statistics. The difference is largely due to China's not counting its exports that are re-exported, probably with little value added, primarily through Hong Kong. Because the re-exporter adds little value, the United States considers these exports (i.e., U.S. imports) to be from China. The U.S. data will be used for the purposes of this analysis.)

China's imports from the United States rose 16 percent in 1989, but contracted by 16 percent in 1990 due to China's desire to limit overall imports. The increase in 1989 was greater than that for China's overall imports (7 percent), but the fall in 1990 was more pronounced than that for total imports (10 percent).

In the domestic economy, an austerity program was instituted in 1988 primarily to counter extreme inflationary pressures and overly rapid growth. The program also was designed to reduce China's overall trade deficit and build-up foreign exchange reserves. The government has, in fact, been especially successful in reimposing control over the external trade system, where reform had previously been the most far-reaching. This has enabled it to reverse the deficits in the external trade account. In addition, foreign exchange reserves have climbed by over \$10 billion, or 38 percent, to \$27.3 billion last year. Such a level is equal to eight months of imports.

In the first quarter of this year, according to China's data, the overall trade surplus was \$2.26 billion, an increase of 183 percent compared to the same period last year. Exports (fob basis) were up 24 percent, while imports grew by only 12 percent. China claimed to have a \$180 million trade deficit with the United States in this period.

U.S. data, however, reveal a \$1.7 billion deficit with China in the first 2 months of this year, a 30 percent increase over last year. This was our second largest trade deficit, behind that with Japan, and bigger than the total deficit with the four Asian NIEs. U.S. imports from China rose by 19 percent, while U.S. exports to China grew by only 2 percent during the period compared to last year.

o Foreign Exchange Allocation and External Trade System

The manner in which foreign exchange is allocated, along with import licenses and other market access barriers, is an important means by which China controls the external trade sector. These pervasive controls are symptomatic of the broader controls which characterize the command structure of the Chinese economy.

An import license is a prerequisite for obtaining a foreign exchange allocation for non-priority imports at the official exchange rate. The licenses are, hence, a primary means of controlling imports. However, even if a foreign trade company has obtained an appropriate import license, it may not be able to obtain a foreign currency allocation.

For priority imports, foreign exchange at the administered rate is allocated to foreign trade companies under the foreign exchange plans of the central, provincial, and local governments. The allocation decision, while not affecting exchange rates, does provide a second control not only on the value of imports, but also on the supplier of any particular product. This control, to the extent purchasers are directed away from U.S. suppliers to other suppliers, increases the U.S. bilateral trade deficit with China.

On the export side, China uses a number of licensing and other administrative means to influence exports. For example, China gives exporting firms priority access to raw materials, energy, and bank loans. An important element in China's export strategy is efforts to target sales to the U.S. market.

o Assessment

It is our assessment that the principal cause of China's bilateral trade surplus and external surpluses appears to be generalized and pervasive administrative controls over external trade, which inhibit imports, including from the United States, and promote exports, particularly to the United States, China's largest market.

The foreign exchange allocation system is a serious problem. Given the substantial reserves, there is no basis for this rationing except to restrict imports and control sources.

There is no clear evidence at this time of direct "manipulation" of the exchange rate itself within the meaning of the law. However, the recent devaluations, in conjunction with large external surpluses, raise concerns and indicate that a shift in exchange rate policy may be occurring aimed at reinforcing China's attempts to generate sizable external surpluses. Such a possibility is a matter of concern to the U.S. Government. In addition, the command nature of China's economy has allowed it to control the allocation of foreign exchange. This has been clearly done in a manner that impedes imports. There is, thus, a need to monitor this situation closely. Certainly, given the substantial real effective depreciation of the official rate of the yuan to date and China's reluctance to eliminate export subsidies and liberalize imports, no case can be made for further real effective depreciation.

There are a number of practical steps that China should consider taking to permit its exchange rate to reflect more fully market forces. First, China should make foreign exchange allocation automatically to companies which either have import licenses or are authorized to import without licenses, thus, removing foreign exchange allocation as another administrative barrier to imports. Second, China should liberalize foreign exchange transactions by permitting more transactions in the swap markets and the unofficial market. China should also eliminate other barriers to obtaining foreign exchange such as the requirement for explicit authorization.

These controls and the surpluses to which they contribute are a matter of concern for the United States Government. Treasury, therefore, intends to discuss China's foreign exchange policies with its authorities with a view to seeing China move toward a more market-oriented exchange rate determination and allocation system.

PART VII: CONCLUSIONS

Substantial changes have taken place in the world economy since the autumn report on International Economic and Exchange Rate Policy.

The Gulf War and its aftermath have highlighted the increasing interdependence of our nations and the world economy. Throughout the world, in Eastern Europe, Latin America, and many other developing countries, fundamental market-oriented reforms are being pursued with vigor.

At the same time, world economic growth has slowed markedly. Since last autumn, the IMF has marked down its growth projection for the major countries in 1991 by over a full percentage point to 1.3 percent. Several countries are experiencing recession.

There are encouraging signs of recovery in some quarters. Inflation is projected to decline significantly this year in the major countries, reflecting the reversal of the run-up in oil prices and the more moderate pace of economic activity. Interest rates have declined sharply in some countries, especially the United States. Current account imbalances have been further reduced, and the adjustment process is continuing in the major countries. Adjustment of structural fiscal deficits is underway in the United States, and this should strengthen national savings.

But a timely recovery of world economic activity is by no means certain. At this juncture, the hopeful signs of recovery have yet to be translated firmly into reality. Economic activity is slowing in those countries which until recently had been experiencing strong expansion. Furthermore, real interest rates remain persistently high in a number of other countries, in part reflecting the influence of regional and international transmission mechanisms. This confluence of factors is dampening investment and growth prospects.

Fostering an open, growing world economy is the most effective tool to meet the challenges of the changing world economy. Against the background of the increased interdependence of nations, countries must work collectively to achieve their common objectives of freedom and prosperity.

In these circumstances, G-7 economic policy coordination will need to play a central role in the world economy. Recognizing this basic reality, the Ministers and Governors of the G-7 countries, at their most recent meeting on April 28, 1991, reaffirmed their support for policy coordination as essential to achieving their common objectives.

In this context, they emphasized the importance of monetary and fiscal policies which provide the basis for lower real interest rates and a sustained global recovery with price stability. They reiterated the importance of policies aimed at increasing global savings and reaffirmed their commitment to cooperate closely on exchange markets. Also, all countries must maintain open markets to meet the challenges of the world economy, and the G-7 Ministers emphasized the importance of bringing the Uruguay Round to a successful conclusion.

Though the major industrial countries bear a special responsibility for the smooth functioning of the world economy, all countries have a role to play in promoting sustained growth with stable prices and adjustment of external imbalances. In this context, it was determined in the October 1988 and April 1989 reports that Taiwan and Korea, within the meaning of 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 October of 1989, it was concluded that there were no clear indications Taiwan was "manipulating" its currency, though there were continued indications of such "manipulation" by Korea. In April of 1990, it was concluded that there were no indications of currency "manipulation," within the meaning of the legislation, in either Taiwan or Korea.

This report has analyzed economic and exchange rate developments in Korea, Taiwan, and China.

Korea's external accounts have undergone substantial adjustment, following the substantial real appreciation of the won in 1988-89. For the first time since 1985, the current account fell into modest deficit in 1990 of \$2.1 billion (0.9 percent of GNP), which included a trade deficit of \$1.9 billion. The bilateral surplus with the United States fell to \$4.1 billion in 1990, down 38 percent from 1989. There continues to be no basis for concluding that Korea is directly "manipulating" its exchange rate for purposes of competitive gain, nor does it appear that Korea is using exchange controls to "manipulate" the exchange rate indirectly for several reasons. Korea's small external deficit will likely persist in 1991; its foreign reserves declined in the first quarter of 1991; and there is no evidence that the Bank of Korea is intervening directly in foreign exchange markets.

We remain seriously concerned, however, that pervasive Korean exchange and capital controls significantly constrain supply and demand in the currency market and distort the exchange rate. Liberalization of these controls is imperative to allow market forces to govern Korea's exchange rate and trade and investment flows, and to enhance the prospects for sustaining Korea's recent balance of payments adjustment. This is particularly important in view of the likelihood that current account surpluses will re-emerge in 1992, generating natural pressures for appreciation of the won.

Fundamental denials of national treatment for foreign financial institutions in Korea remain. The Korean Government has done little to address the need for broader liberalization of its tightly controlled financial markets, including deregulation of interest rates and elimination of credit allocation schemes. The Treasury Department views these issues as evidence that the Korean Government is unwilling in certain important areas to address the fundamental concerns of the United States. We will therefore continue to monitor developments in Korea's exchange rate and external adjustment, to press for liberalization of Korea's financial, capital, and exchange markets, and to seek improved treatment of U.S. financial institutions in Korea.

Taiwan's global current account surplus decreased by 4.6 percent in 1990 to \$10.9 billion, which included a 10 percent drop in its trade surplus to \$12.5 billion. Taiwan's bilateral trade surplus with the United States also fell by 14 percent to \$11.2 billion. With the decline in Taiwan's external surpluses and the continued liberalization of the exchange rate system, we have no evidence of direct exchange rate "manipulation" for purposes of unfair competitive gain. But Taiwan's persistent external surpluses remain too large, and their decline needs to be accelerated. Exchange rate appreciation will likely need to play a role in this process. In addition, Taiwan's exchange restrictions, while less pervasive than Korea's, impede the full operation of market forces in exchange rate determination. The Treasury Department will continue to monitor developments and to urge the authorities to liberalize exchange restrictions further.

China's current account, which had been in deficit in recent years, moved dramatically into a surplus of \$10.2 billion in 1990, 2.8 percent of GNP, with a trade surplus of \$9 billion. China's large and growing trade surplus with the United States rose 67 percent to \$10.4 billion in 1990. These developments chiefly reflect China's generalized and pervasive controls over the external sector, including both import restrictions and the allocation of foreign exchange. These controls, in conjunction with China's administrative determination of its exchange rate and sustained real effective depreciation in 1990, raise concerns and indicate a shift in policy may be occurring aimed at reinforcing China's attempts to generate significant external surpluses. The Treasury Department intends to discuss China's exchange policies, including exchange rates and exchange allocation, with its authorities with a view toward promoting a more market-oriented and less distorted exchange rate and exchange allocation system.

APPENDIX

TABLES AND CHART

1. Economic Performance of Key Industrial Countries
2. Measurements of Dollar Movements Versus G-7 Currencies
3. Summary of U.S. Current Account
4. Summary of U.S. Capital Account Flows
5. Asian NIEs and China: Trade and Currency Changes
6. Chart: Real Trade-Weighted Exchange Rate Indices for the Dollar, Yen, and DM

TABLE 1

Economic Performance of
Major Industrial Countries

	<u>GNP 1/</u>			<u>Domestic Demand 1/</u>		
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>
U.S.	2.5	1.0	0.2	1.9	0.5	-0.5
Japan	4.7	5.6	3.6	5.7	5.8	3.6
Germany	3.8	4.5	2.8	2.7	5.1	2.4
France	3.7	2.8	2.1	3.3	3.1	2.3
U.K.	1.8	0.6	-2.1	2.9	-0.1	-2.9
Italy	3.2	1.9	1.7	3.3	1.9	1.7
Canada	<u>3.0</u>	<u>0.9</u>	<u>-1.1</u>	<u>4.2</u>	<u>0.0</u>	<u>-1.3</u>
G-7 2/	3.1	2.6	1.3	3.1	2.4	0.9
	<u>Inflation 3/</u>			<u>Current Account 4/</u>		
	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>
U.S.	4.8	5.3	4.9	-2.1	-1.8	-0.7
Japan	2.3	3.1	4.0	2.0	1.2	1.3
Germany	2.8	2.7	3.5	4.6	2.7	0.6
France	3.5	3.4	3.2	-0.4	-0.6	-0.5
U.K.	7.8	9.5	6.0	-3.9	-2.4	-1.5
Italy	6.3	6.5	6.2	-1.2	-1.4	-1.5
Canada	<u>5.0</u>	<u>4.8</u>	<u>5.6</u>	<u>-2.6</u>	<u>-2.4</u>	<u>-1.7</u>
G-7 2/	4.5	5.0	4.6	-0.5	-0.6	-0.2

*Data for 1989 and 1990: national sources and International Monetary Fund. Forecasts for 1991: International Monetary Fund, World Economic Outlook (May 1991).

1/ Annual average rates in real terms.

2/ Average of individual country rates, weighted by GNP.

3/ Consumer prices; annual average.

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

Table 2

Measurements of Dollar Movements (for key dates)
Versus G-7 Currencies
Percent Dollar Appreciation (+) or Depreciation (-)

As of April 12, 1991

Value of the Dollar in Terms of:	Since Dollar Peak 26-Feb-85 to Date	Since Plaza Accord 20-Sep-85 to Date	Since Louvre Accord 20-Feb-87 to Date	Over Last Year 12-Apr-90 to Date	Since Previous Report 12-Oct-90 to Date
Japanese yen	-48.2	-43.8	-11.7	-14.4	+5.2
German mark	-51.9	-41.5	-8.5	-0.2	+9.8
British sterling	-41.9	-23.8	-14.6	-8.2	+10.1
French franc	-46.7	-35.2	-7.1	+0.4	+10.9
Italian lira	-42.8	-35.4	-4.4	+0.8	+8.9
Canadian dollar	-18.1	-16.4	-13.4	-1.4	+0.4

Table 3

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

	Quarters												Annual	
	89:1	89:2	89:3	89:4	90:1	90:2	90:3	90:4	1988	1989	1990			
Total Exports	88267	91111	89349	91738	96093	96585	96152	100456	320337	360465	389286			
Agricultural	10647	10677	9917	10225	10938	10317	9728	9374	38237	41466	40357			
NonAgricultural	77620	80434	79432	81513	85156	86268	86424	91082	282100	318999	348930			
Total Imports	116360	119333	119152	120484	122902	119810	125938	129317	447323	475329	497967			
Petroleum	10879	13519	13173	13322	15592	12164	15643	18709	39632	50893	62108			
Non-Petroleum	105481	105814	105979	107162	107310	107646	110295	110608	407691	424436	435858			
TRADE BALANCE	-28093	-28222	-29803	-28746	-26809	-23225	-29786	-28861	-126986	-114864	-108681			
Partial Bal (Excl. Ag Exps & Petimps)	-27861	-25380	-26547	-25649	-22154	-21377	-23871	-19526	-125591	-105437	-86929			
Net Services	4544	2579	5742	6685	7929	4914	7403	10211	13131	19550	30457			
Invest. Income	465	1957	17	561	2004	-990	2256	4265	1609	-914	7535			
Other Services	4079	4536	5725	6124	5925	5904	5147	5946	11522	20464	22922			
Total Transfers	-3555	-3006	-3530	-4631	-3440	-4422	-4099	-9112	-15005	-14722	-21073			
Remits & Pensions	-999	-962	-909	-889	-1038	-921	-1106	-1037	-4262	-3759	-4102			
Govt Grants	-2556	-2044	-2621	-3742	-2402	-3501	-2993	-8075	-10743	-10963	-16971			
NET INVISIBLES	989	-427	2212	2054	4489	492	3304	1099	-1874	4828	9384			
CURRENT ACCOUNT	-27104	-28649	-27591	-26692	-22320	-22733	-26482	-27762	-128860	-110036	-99297			

Source: Survey of Current Business, March 1991

Table 4

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

	Quarters										Annual	
	89:1	89:2	89:3	89:4	90:1	90:2	90:3	90:4	1988	1989	1990	
US Reserve Assets (Incr(-)Decr(+))	-4000	-12095	-5996	-3202	-3177	371	1739	-1091	-3913	-25293	-2158	
Other Govt Assets	962	-303	574	-47	-659	-808	-360	4797	2968	1186	2970	
Foreign Official Assets	7797	-4967	13003	-7016	-8203	5541	13588	19851	39515	8823	30777	
Industrial	1646	-7021	7540	-2253	-7500	6413	13092	12224	30306	-88	24229	
OPEC	7100	460	4532	-1379	2953	208	-1600	341	10713	10713	1902	
Other	-949	1600	931	-3384	-3656	-1080	2096	7286	12205	-1802	4646	
Banks, net:	-6100	6023	6576	4016	20089	-8742	14102	-4847	13913	10515	20602	
Claims	-23586	26829	-21269	-32658	52353	-13639	-13489	-24409	-56322	-50684	816	
Liabilities	17486	-20806	27845	36674	-32264	4897	27591	19562	70235	61199	19786	
Securities, net	15992	5769	13465	12355	-5845	-4743	-2581	-8376	38747	47581	-21545	
Foreign Securities	-2062	-6144	-9623	-4109	-7496	-11247	-1223	-6819	-7845	-21938	-26785	
U.S. Treasury Securities	9323	2339	12618	5671	-835	3614	312	-1947	20239	29951	1144	
Other U.S. Securities	8731	9574	10470	10793	2486	2890	-1670	390	26353	39568	4096	
U.S. Direct Invest. abroad	-6024	-7284	-9639	-8776	-9318	-4821	-19186	-3045	-16218	-31723	-36370	
Reinvested Earnings	-6165	-5342	-6694	-4215	-5764	-3575	-6341	-5971	-12615	-22416	-21651	
Equity & Inter-co. Debt	141	-1942	-2945	-4561	-3554	-1246	-12845	2926	-3603	-9307	-14719	
For. Direct Invest. in U.S.	21348	17055	12375	21466	5537	7236	11885	1050	58435	72244	25708	
Reinvested Earnings	-2438	1824	1204	-678	-2138	-826	-2106	-4871	6561	-88	-9941	
Equity & Inter-co. Debt	23786	15231	11171	22144	7675	8062	13991	5921	51874	72332	35649	
Other U.S.-Corp., net	5568	-2791	-298	1779	1492	-233	5050	n.a.	3817	4258	6309	
Claims	1851	-2384	1877	47	1202	-1550	625	n.a.	-2847	1391	277	
Liabilities	3717	-407	-2175	1732	290	1317	4425	n.a.	6664	2867	6032	
NET CAPITAL FLOWS	35543	1413	30060	20575	-84	-6199	24237	8339	137264	87591	26293	
Statistical Disc.	-8439	27236	-2469	6117	22404	28932	2244	19424	-8403	22445	73004	
TOTAL	27104	28649	27591	26692	22320	22733	26481	27763	128861	110036	99297	

Source: Survey of Current Business, March 1991

TABLE 5

ASIAN NIES AND CHINA: TRADE AND CURRENCY CHANGES

Cumulative Change against US\$ as of April 12, 1991

from:	(Plaza) 9/20/85	end-86	end-87	(Report) 10/14/88	end-89	end-90	Rate on 4/12/91
HK\$	0.31%	0.00%	-0.39%	0.30%	0.19%	0.12%	HK\$ 7.79
Won	23.24%	18.67%	9.16%	-2.14%	-6.49%	-1.30%	W 725.80
Singapore\$	25.23%	23.44%	13.45%	14.97%	8.08%	-1.11%	S\$ 1.76
NT\$	48.55%	30.15%	4.67%	5.95%	-4.07%	-0.62%	NT\$ 27.28
Yen	77.76%	17.16%	-9.26%	-7.19%	5.45%	-0.42%	Y 136.22
DM	71.39%	15.16%	5.18%	7.15%	0.42%	-11.18%	DM 1.68
Yuan	-43.73%	-29.43%	-29.43%	-29.43%	-10.25%	-1.01%	Yuan 5.27

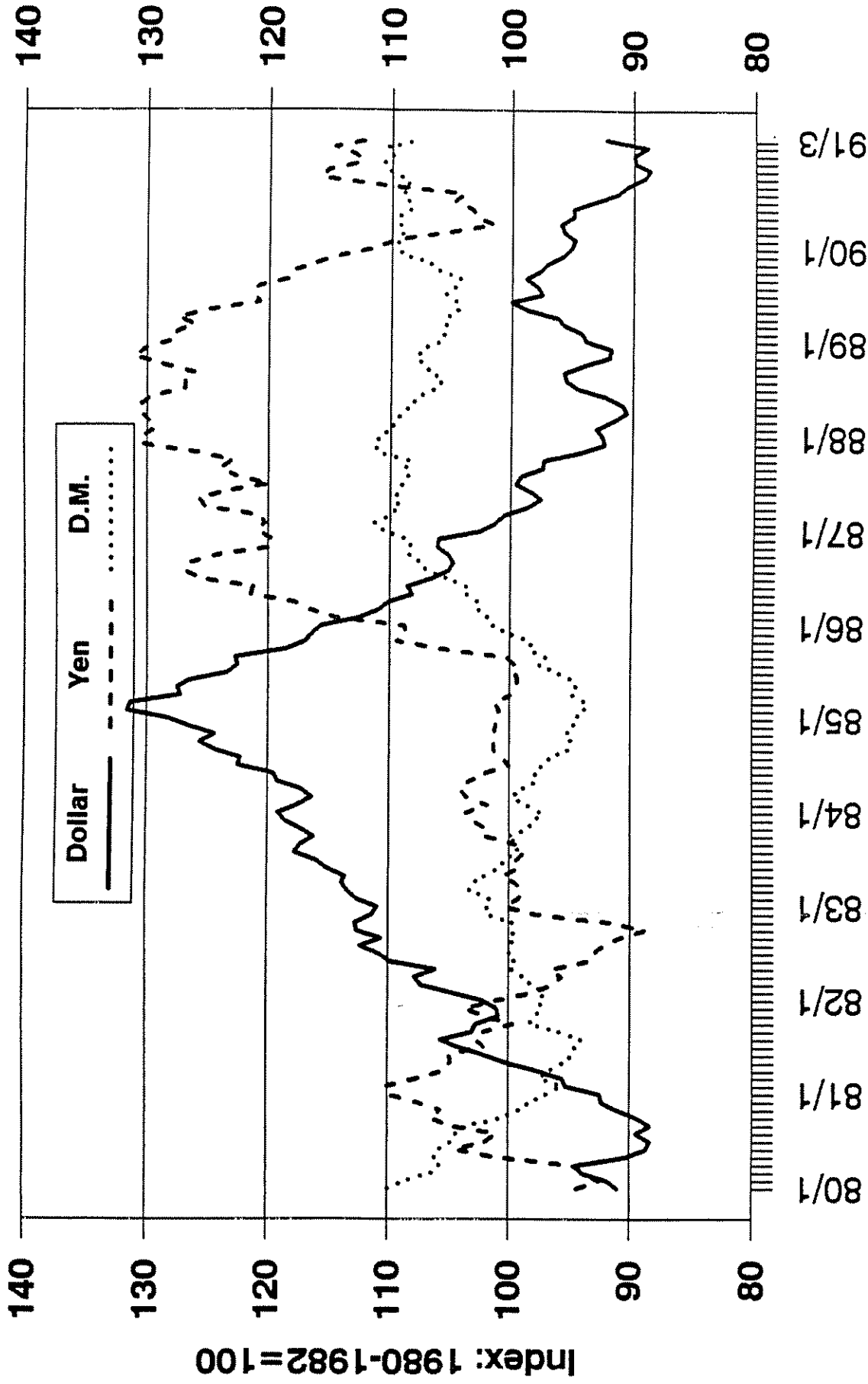
* [-] signifies depreciation against the U.S. dollar.

U.S. Trade Balance with Asian NIEs and China [1]
(U.S. \$ Billions)

	1985	1986	1987	1988	1989	1990	1-2/90	1-2/91	% Change
Hong Kong	-5.6	-5.9	-5.9	-4.6	-3.4	-2.6	-0.4	-0.1	-72.6%
Korea	-4.1	-6.4	-8.9	-8.9	-6.3	-4.1	-0.7	0.0	-101.9%
Singapore	-0.8	-1.3	-2.1	-2.2	-1.6	-1.8	-0.3	0.1	-128.5%
Taiwan	-11.7	-14.3	-17.2	-12.6	-13.0	-11.2	-1.8	-1.5	-12.2%
TOTAL NIEs	-22.1	-27.8	-34.1	-28.2	-24.3	-19.7	-3.2	-1.6	-50.9%
China	0	-1.7	-2.8	-3.5	-6.2	-10.4	-1.3	-1.7	29.7%
Total U.S. Trade Bal.	-132.1	-152.7	-152.1	-118.5	-108.6	-101.0	-18.0	-11.5	-28.3%
NIEs % Total U.S. Trade Bal.	17%	18%	22%	24%	22%	20%	20%	14%	
China + NIEs % Total U.S.	17%	19%	24%	27%	28%	30%	28%	28%	

[1] U.S. customs value data, not seasonally adjusted.
Totals may not equal sum of components due to rounding.

Real Trade-weighted Exchange Rate Indices for the Dollar, Yen, and DM from 80/1 to 91/3*



*Source:JP Morgan; 1980 trade weights (18 industrial and 22 developing countries; 1980-82 = 100.

