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Report to the Congress

on

International Economic and Exchange Rate Policy

April 1990

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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 October of 1988 and 1989. The first written update of developments was submitted in April 1989. This report represents the second written update of developments submitted to Congress.

Part II of this report reviews the economic situation in the industrial countries, including the U.S. economic and balance of payments situation. Part III analyzes the situation in the foreign exchange markets, including the dollar's movement in terms of the currencies of major U.S. trading partners and U.S. foreign exchange market intervention. Part IV reviews efforts by the major industrial countries to coordinate economic policies. Part V provides a status report on negotiations with Korea, which was considered in the October 1989 report to be "manipulating" its exchange rate, within the meaning of the legislation. It also reviews developments in Taiwan. The final part provides conclusions on the principal issues discussed in the report.

PART II: ECONOMIC SITUATION IN THE INDUSTRIAL COUNTRIES AND THE U.S. BALANCE OF PAYMENTS

o Overview

The economic expansion in the industrial countries continued through its seventh consecutive year in 1989, at an average rate that was, as expected, somewhat below the very strong pace of 1988. Aggregate real GNP growth is expected to ease a bit further this year, to a still satisfactory rate of about 3.0 percent, with a greater divergence in the performance of individual countries reflecting both policy measures and cyclical factors. Prospects for continued steady growth remain good.

Substantial progress was made last year in reducing the trade and current account imbalances of the United States and Japan. However, the external imbalances of other major countries, such as Germany and the United Kingdom, increased further in 1989, and the underlying pace of the overall adjustment process appears to have slowed in some important respects. Nevertheless, market opening measures in Eastern Europe and, particularly, the economic integration of West and East Germany, could provide substantial impetus to the external adjustment process over time, especially within Europe.

Consumer price inflation in the industrial countries rose by approximately one percentage point in 1989, to an average rate of about 4.5 percent. The increase, which was broadly consistent with expectations, in part reflected the influence of some special, transitory, factors during the first half of the year. Since then, however, price pressures have generally moderated or stabilized, and the average inflation rate is likely to slip back marginally to slightly below 4 percent in 1990. (See Table 1.)

o Economic Growth

Basic developments in real GNP and its components were remarkably uniform in the major industrial countries in 1989. Specifically, after GNP growth rates picked up strongly in 1988 (to what, for several countries, were decade highs), there was a broadly shared slowdown in 1989. Japanese growth dipped to 4.9 percent (still the strongest rate in the G-7), and U.S. growth to 3.0 percent; the largest declines were registered for the United Kingdom and Canada (to 2.3 and 2.9 percent, respectively); only in Germany was GNP growth stronger in 1989 than in 1988 (4.0 percent vs. 3.6 percent). Aggregate GNP growth for the G-7 countries was an estimated 3.4 percent last year, after 4.5 percent in 1988. Domestic demand followed a similar course, with G-7 growth easing from 4.7 percent in 1988 to 3.4 percent in 1989.

Two major factors accounted for the bulk of last year's domestic demand slowdown. First, while investment activity remained generally strong, there was a fairly widespread easing from the unexpectedly high growth rates in 1988. Contributing to the slowdown were a moderate scaling back of investment plans in the wake of the large increases in recent years, narrowed profit margins, and anticipation of a period of somewhat weaker demand growth ahead. Second, private consumption growth declined in each of the G-7 countries in 1989, pulling the aggregate growth rate from 3.7 percent in 1988 to about 3 percent; among the contributing factors were the limiting effects of selected tax and social payment increases and higher inflation on real disposable income gains, as well as, in some cases, higher household saving.

Aggregate macroeconomic developments in the United States and Japan continued to provide solid support for the current account adjustment process. In the United States, domestic demand grew more slowly than GNP for the third consecutive year, and improving net exports once again provided a significant growth impetus. The reverse was the case in Japan, where domestic demand growth again substantially exceeded GNP growth and net exports declined significantly. In Germany, however, domestic demand growth weakened appreciably (due in part to fiscal tightening), and lagged GNP growth by a considerable margin; rising net exports were thus an important source of overall growth. Macroeconomic developments in the United Kingdom (with a very large current account deficit) moved strongly in the direction of adjustment in 1989 as domestic demand growth cooled from its unsustainably high rate in 1988. Nevertheless, domestic demand growth in the United Kingdom (as well as in Canada) remained in excess of GNP growth.

Macroeconomic trends are expected to be broadly supportive of external adjustment within the G-7 again this year. As domestic demand growth eases further in the largest deficit countries (the United States, the United Kingdom and Canada), net exports should also improve. Although domestic demand growth in Japan is not likely to be as strong as in 1989, it should again exceed GNP growth, with net exports contracting further. Modest real external adjustment is likely in Germany as well this year, as a tax cut and economic integration with the German Democratic Republic boost domestic demand. Over the longer term, German economic and monetary union should have a positive and substantial effect in reducing Germany's external imbalances.

o <u>Trade and Current Account Developments</u>

World trade in 1989 largely reflected the macroeconomic developments discussed above: trade volume growth was not quite as robust as in 1988 (at 9.1 percent, the best year of the decade), but nevertheless remained quite strong (about 7.5 percent). Thus, the relationship between trade and output growth continues to track well with historical experience (roughly a 2:1 ratio).

The external imbalances of the two largest economies, the United States and Japan, declined substantially in 1989. Latest available data indicate that the U.S. current account deficit fell about an additional $21 billion in 1989, from $126.5 billion to $105.9 billion (2.0 percent of GNP); the trade deficit fell to $113.2 billion (2.2 percent of GNP). Japan's current account surplus declined from $79.6 billion in 1988 to $57 billion in 1989 (2.0 percent of GNP), and its trade surplus from $95 billion to $77.1 billion (2.7 percent of GNP). The aggregate current account surplus of the European Community (EC) fell to nearly zero last year after having been as high as $51 billion in 1986.

However, the overall external adjustment of the EC conceals some major imbalances that have developed among Community members. In particular, Germany's trade and current account surpluses continued to rise in 1989; at $72 billion and $53 billion, respectively, the German imbalances represent 6.5 and 4.4 percent of GNP, the largest such ratios in the G-7. The bulk of the increase in German surpluses has come in trade with other EC member countries, with which Germany's surplus has more than tripled since 1985. However, the impact of the growing German surpluses on the overall external position of the EC has been essentially offset by rising deficits in other member countries, especially the United Kingdom and Spain. The trade and current account deficits of the United Kingdom increased somewhat further in 1989, to $37 billion (4.5 percent of GNP) and $33 billion (4 percent of GNP), respectively.

These external account trends in 1989 partly reflect developments in the relative growth rates of exports and imports in individual countries. In the United States, real exports of goods and services (measured on the national accounts basis) increased nearly 11 percent (the third consecutive year of double digit growth) while import growth was 6.4 percent. Import growth of 21 percent in Japan again exceeded export growth (about 15 percent), though the latter strengthened substantially last year. In Germany, however, export growth accelerated to just over 10 percent, exceeding import growth of about 7 percent; and while import growth in the United Kingdom slowed and export growth strengthened, the former still exceeded the latter by about 7 percent to 4 percent.

Thus, underlying trade flows present a mixed picture of adjustment. U.S. trends continue to favor adjustment, though the pace of export growth has cooled; in Japan, import growth remains strong, but export growth has revived considerably; export growth revived strongly as well in Germany, but imports picked up only marginally.

Against the background of these underlying trends, and in light of the macroeconomic projections reviewed above, further external adjustment in the industrial countries is expected this year, but the composition and extent of the adjustment is open to question. In the United States and Japan, where adjustment has been the greatest in recent years, additional progress is likely to be much smaller and a modest widening of nominal imbalances cannot be excluded. Basic developments have brightened the adjustment prospects for Germany, but the very large existing imbalances suggest that substantial imbalances will remain.

However, developments in Europe could provide substantial impetus to the industrial country adjustment process over the next few years, with early signs perhaps beginning to emerge later this year. The unification of the two German economies is likely to be especially significant. The large population inflow into West Germany is already raising German domestic demand, due in part to the fiscal stimulus associated with higher transfers and infrastructure outlays. The additional demand can be met without undue inflationary consequences by diverting West German exports to domestic uses and by increasing imports. The net effect, over time, could thus be a significant reduction in the German surplus and a substantial increase in trade opportunities for non-German suppliers.

o <u>Inflation</u>

The increase in average inflation rates in the industrial countries in 1989 reflected the combined impact of several developments, including higher oil prices, excise tax increases in various countries, and generally higher capacity utilization rates. However, the bulk of the price runup occurred during the first half of the year, and for most countries inflation rates have tended to level off or subside since then.

A number of other factors appear likely to reinforce this more recent trend, which should push inflation moderately lower, on average, this year. Slower output and demand growth, coupled with the vigorous investment activity of the past few years, should ease pressures arising from higher capacity utilization and wage demands; and, the monetary and fiscal authorities are, for the most part, likely to continue to pursue a fairly restrictive course.

As a result, consumer price inflation is forecast to ease somewhat in each of the major industrial countries this year and to decline to slightly below 4 percent in the industrial countries in aggregate. Japan, Germany and France are expected to remain at the lower end of the G-7 group, with the United States and Canada in the middle, and Italy and the United Kingdom at the upper end.

U.S. Balance of Payments Developments and Trends

o Developments in 1989

The U.S. trade deficit, after declining markedly (by $32 billion) to $127 billion in 1988, fell further in 1989 to $113.2 billion. The 1989 trade deficit was the lowest since 1984. The improvement occurred largely in the first half of the year as the pace of adjustment slowed over the course of 1989.

The continued, but slowed decline in the trade deficit reflected moderation in both export and import growth. In 1989, exports rose 13.4 percent in value (11.8 percent in volume), well below the corresponding performance in 1988 when export values had surged 27.6 percent (23.5 percent in volume). Most commodities shared in the rather general, small slowing of export value growth in the latter half of 1989. The largest changes occurred in foods, feeds and beverages, and in the typically "lumpy" completed civilian aircraft sector. Import growth also slowed -- from 8.8 percent (6.5 percent in volume) in 1988 to 6.4 percent (5.6 percent in volume) in 1989. (See Table 2.)

Two on-going phenomena affected 1989 imports, and are likely to continue to influence U.S. trade data. Petroleum imports were up by $10.9 billion in value, to $50.2 billion in 1989, their highest level since 1985. Oil prices rose 19 percent; quantities were up 7.75 percent to 8.06 million barrels per day, a figure not seen since 1979. Total automotive imports actually declined in 1989; those from Japan declined for the third consecutive year. Along with a softening of demand for autos generally, the increases in production and sales by foreign-owned auto producers in the United States were a major factor slowing automobile imports.

Geographically, the 1989 decline in the trade deficit was concentrated in Western Europe; that bilateral trade deficit dropped $12.1 billion to $3.6 billion. Deficits with other countries or regions fell by lesser amounts: the deficit with the newly industrialized countries of the Far East fell $4.3 billion, to $25 billion; that with Japan dropped $2.9 billion, to $49.7 billion; and that with Canada by $2.4 billion to $8.5 billion. The only major bilateral trade deficit to increase was that with OPEC which was up $8.4 billion to $17.1 billion.

The 1989 deficit on the balance on current account was also the lowest since 1984. It stood at $105.9 billion, down $20.6 billion from $126.5 billion in 1988. For the year as a whole, the reduction in the trade deficit accounted for about two-thirds of the current account decline (some $14 billion), while an improved position on services (see below) accounted for the remaining third (about $7 billion).

The difference between the trade balance and the balance on current account largely reflects U.S. performance in services. The surplus on service transactions had peaked in 1981 at $43.8 billion; until 1986, the balances generally indicate an underlying deterioration in these accounts. However, in 1988 and 1989, the services surpluses were $15.4 and $22 billion respectively. Last year, services trade shifted from approximate balance in the first half to a surplus of almost $22 billion in the second. But that shift incorporated a swing from capital losses (some $8 billion) in the first half to capital gains (also $8 billion, for a total swing of $16 billion) in the second. Those losses and gains reflect the effects of exchange rate changes on the conversion of U.S. foreign investors' foreign currency profits to dollars. Whether, therefore, the full-year figure for 1989 services trade suggests some reversal of the previous declining trend in that position remains uncertain.

The recorded net inflow of capital in 1989 was $125.7 billion; unrecorded transactions (the statistical discrepancy) were $34.9 billion. Major contributors to the gross inflow were a record amount of inward direct investment ($61.3 billion, up from the previous high of $58.4 in 1988), and foreign private purchases of U.S. securities ($40.3 billion). On the outflows side in 1989, there was a substantial increase ($25.3 billion) in U.S. official reserve assets, reflecting exchange market intervention activity; direct investment outflows rose strongly (by $14.8 billion) to $32.3 billion, while purchases of foreign securities nearly trebled to $22.6 billion. (See Table 3.)

Prospects for 1990

As has been discussed, the U.S. trade deficit continued to decline in 1989, following its significant fall in 1988 from its 1987 peak. However, the pace of external adjustment slowed.

The outlook for 1990 is difficult to project with certainty. Most model-based forecasts project a modest widening in the U.S. current account deficit, although some project little change or even a slight improvement. These projections, however, are influenced by assumptions such as no policy changes, constant exchange rates, and unchanged structural characteristics of the U.S. and other major economies.

While conventional models provide very important information, they cannot capture the full range of factors at play in a dynamic world economy. For example, these models for the most part do not take into account the structural implications of recent developments in Eastern Europe and the prospective reunification of the two German economies. Also, they do not take into account the most recent exchange market developments, nor do they explain the strong role foreign direct investment may be playing in producing longer term and continuing adjustment of the current account. Furthermore, important developments that have taken place in the performance of the U.S. services account are less well understood than the merchandise trade accounts.

Despite our view that positive factors are at work in encouraging medium term external adjustment and that these factors are not captured by conventional models, it would appear that further improvement in the U.S. current account position in 1990 is likely at best to be very modest. Furthermore, the possibility of deterioration in the current account cannot be excluded.

PART III: FOREIGN EXCHANGE MARKET DEVELOPMENTS

o Overview

Over the past six months, foreign exchange market activity was characterized by an appreciation of the German mark in late 1989 and a depreciation of the yen in early 1990.

Since the October 1989 report, the German mark has appreciated by 10 percent against the dollar, while the Japanese yen depreciated by 11 percent (as of April 10). Against the mark, the yen depreciated by 19 percent. Continental European currencies generally mirrored the movement of the mark against the dollar. The British pound ended the period little changed. Early in this period, the market perceived the G-7 as favoring a lower dollar and remained generally wary of dollar intervention sales. (See Table 4.)

The period since the October 1989 report can be subdivided into two parts. The first, from October 1989 to January 1990, was characterized by appreciation of the mark in the aftermath of the September 1989 G-7 Statement and in response to developments in Eastern Europe, including East Germany. The second, from January through mid-April, was highlighted by a sharp depreciation of the Japanese yen.

In market intervention, U.S. authorities sold $2.5 billion between October and January.

October 1989 through January 1990: DM Appreciation

In the October-January period, the exchange value of the German mark rose in the aftermath of the September 1989 G-7 Statement, in response to changes in monetary policies in Germany and the United States, and in reaction to favorable perception of political changes occurring in Eastern Europe, notably the opening of the East German border and growing prospects for German unification, which were seen as providing attractive opportunities for real investment. During this time, the U.S. economy showed signs of slowing, and participants anticipated that changes in interest differentials would tend toward favoring placements in foreign currencies. However, foreign investor interest in German assets paused after the turn of the year, as uncertainties regarding German Economic and Monetary Union (GEMU) raised concerns about its potential inflationary risks. Such concerns moderated somewhat after the East German election in mid-March.

Foreign exchange markets were impressed by the forcefulness of the September 23, 1989, Statement of the G-7, which noted:

"The Ministers and Governors considered the rise in recent months of the dollar inconsistent with longer-run economic fundamentals. They agreed that a rise of the dollar above current levels or an excessive decline could adversely affect prospects for the world economy. In this context, they agreed to cooperate closely on exchange markets."

The G-7 monetary authorities intervened aggressively in the weeks immediately following the Statement.

Following the G-7 Statement and coordinated intervention, participants anticipated changes in official interest rates that would reinforce the desired trend in exchange rate movements. In the event, the Bundesbank raised its official rates by 1 percentage point (discount rate to 6 percent, Lombard rate to 8 percent) on October 5, 1989. The Bank of Japan raised its discount rate by 1/2 percentage point to 3-3/4 percent on October 11, 1989, and to 4-1/4 percent on December 25, 1989. The Federal Reserve eased reserve conditions in successive steps, with the result that the Fed funds rate fell from 9 percent at the end of September to 8-1/4 percent by the end of December.

With these changes in the relative stances of monetary policies, around mid-November, German interest rates neared U.S. interest rates, and this narrowing of interest rate differentials supported the mark's appreciation in late 1989. Meanwhile, indications of slowing U.S. economic activity fostered market expectations of moderating growth, diminished price pressures, and further declines in U.S. yields. (The October 13 stock market drop only sharpened market participants' focus on the perceived weakening in U.S. economic fundamentals, and by early December, the softness in the economy was viewed as confirmed by the U.S. November employment data.)

Elsewhere, economic activity remained more buoyant, and the West German economy in particular was thought to be operating near capacity. The opening of the East German border in early November was seen as likely to provide a further stimulus to growth and investment and, consequently to raise real yields on DM assets. German monetary officials welcomed the DM's rise against the dollar. Also, in late October, German monetary officials reportedly had begun expressing interest in a revaluation of the DM within the European Monetary System (EMS), and this contributed to the rise of the DM into early January, when the Italian lira was realigned in the EMS and Italy joined the narrower ±2-1/4 percent band.

Around mid-January, however, flows from dollars into marks stalled as the market grew increasingly concerned about the potential inflationary implications of GEMU. Meanwhile, flows into dollars were supported by some perceptions of a pickup in U.S. economic activity. The mark then began trading within a moderate range, slightly off its January highs, with its movements against the dollar at times influenced by developments in Eastern Europe and the Soviet Union.

February - April: Bearishness Toward the Yen

Between October and January, the yen traded in a fairly narrow range against the dollar. However, the yen had already declined considerably against the German mark in late 1989, as market concern about the inflation of Japanese asset values became evident. Substantial flows from Japan into German equities were registered at that time, although the effect on Japanese asset values was masked by the climb of Japanese stock prices to record levels by end-December.

Since mid-February, the yen has weakened substantially against other major currencies more generally, including the dollar, in response to to political uncertainties in Japan, market perceptions about the stance of official Japanese interest rate policy, and unease associated with the decline in Japanese equity markets. The decline of the yen became particularly pronounced in March. Also, during this period, U.S. interest rates rose and some participants took the view that U.S. economic growth might be "bottoming out."

Sentiment towards the yen in late January and early February was affected by political uncertainties ahead of the mid-February elections and the reluctance to tighten monetary policy further. The depreciation of the yen accelerated after the Japanese monetary authorities did not hike interest rates in the wake of the ruling Liberal Democratic Party's February 18 election victory and as Japanese equity markets declined. Market perceptions that an opportunity to raise official rates had been missed seemed to crystallize pessimism toward the yen. Subsequently, bearishness toward the yen increased rapidly in light of the market's concerns about Japanese economic policy and political conditions. Market perceptions of U.S.-Japan trade tensions were also bearish for the yen.

In this period, expressions of concern about yen depreciation by leading Japanese monetary officials, and about attendant risks to Japanese inflation and trade adjustment, were outweighed in the market's eyes by the absence of a change in the discount rate and the political uncertainties. Moreover, some Japanese monetary authorities repeatedly suggested that, barring a sharp drop of yen, they would rely on intervention rather than interest rates to support the yen. At the same time, however, the market came to believe increasingly that the yields on yen assets should be adjusted upward. A 1 percentage point discount rate hike (to 5-1/4 percent on March 20) came amid active buying of dollar assets that kept the yen, and Japanese stocks and bonds, under pressure throughout March. This hike had been largely discounted in advance, and the market looked for another hike in the near term.

In early March, President Bush and Prime Minister Kaifu reaffirmed cooperation on exchange rates. Later, market participants concluded that a meeting between U.S. Treasury Secretary Brady and Japanese Finance Minister Hashimoto did not produce commitments to support the yen. However, reports that the G-7 would meet on April 7 instilled caution into the markets.

The G-7 Ministers and Governors stated at their April 7 meeting that the decline of the yen against other currencies was having undesirable consequences for the global adjustment process. After appreciating slightly immediately following the G-7 announcement, the yen eased back to levels slightly below those prevailing prior to the meeting.

During the February through April period, the DM has traded narrowly against the dollar. Despite market concerns over the implications of GEMU in this period, participants felt GEMU would also support German growth. They also reacted favorably to the mid-March election outcomes in East Germany.

PART IV: ECONOMIC POLICY COORDINATION

In recent years, the major industrial countries have developed the G-7 economic policy coordination process to put in place the consistent and compatible economic policies necessary for sustained growth with low inflation, reduced external imbalances and greater stability of exchange rates. Under this process, substantial progress has been made in achieving the G-7's shared objectives.

The economic expansion has been sustained for eight consecutive years. Economic growth is slowing in several countries this year to more sustainable levels. However, overall growth prospects remain good. Inflation remains contained, reflecting the vigilance of authorities as well as the subsiding of temporary factors last year. External imbalances have been reduced, particularly in Japan and the United States.

These favorable developments have occurred in part due to the important role of the coordination process in promoting greater stability of the international monetary system in the face of significant changes, at times, in the world economy. Since the October report, further significant fundamental changes have taken place, including most notably the efforts of Eastern European countries to restructure political and economic life, and developments in global financial markets, particularly in Japan. Economic policy coordination, including cooperation in exchange markets, represents the most effective means of assuring that these profound changes now underway are managed in an orderly manner that contributes to the G-7's shared objectives.

Against this background, the G-7 Finance Ministers and Central Bank Governors met in Paris on April 7 to take stock of these changes and to review economic and financial developments in their countries. They noted that the major countries will need to continue their close cooperation on macroeconomic and structural policies and remain vigilant against current inflation rates. Both surplus and deficit countries have a shared responsibility to promote an open and growing world economy. Deficit countries, including the United States, should further reduce budget deficits and increase private savings. Surplus countries must contribute to external adjustment by promoting non-inflationary growth of domestic demand.

The depreciation of the Japanese yen has occurred in the context of a significant adjustment in Japanese equity prices as well as a correction in other Japanese asset values. The yen's weakness is a matter of concern, with undesirable consequences for the global adjustment process. The G-7 will keep these developments under review.

The restructuring of Eastern European economies away from central planning towards market-orientation will represent one of the key challenges of the 1990s. In this regard, the prospective unification of the German economies should contribute to improved global growth, to increased investment opportunities, and to a further reduction of external imbalances. Strong German domestic demand growth and a reduced current account surplus would be most welcome, especially in light of Germany's extremely large current account surplus and forecasts suggesting this surplus could widen further this year to roughly $65 billion, equivalent to nearly 5 percent of GNP.

PART V: ASIAN NEWLY INDUSTRIALIZED ECONOMIES (NIEs)

Overview

Since the release of the October 1989 report, both Korea and Taiwan's exchange rate have depreciated against the dollar. The New Taiwan (NT) dollar was stable following the October report, depreciated in early March, and has since firmed slightly. On balance, NT dollar depreciation since October has totaled 2 percent. The Korean won has steadily depreciated since the October report by a total of 5 percent against the dollar. Over the longer term, however, the NT dollar has strengthened by 54 percent and the Korean won by 27 percent since the Plaza Agreement in September 1985. (See Table 5.)

The Treasury Department began discussions with the Asian NIEs in summer 1986 on their exchange rate and related policies against the backdrop of their rising external surpluses, particularly their surpluses with the United States. The U.S. merchandise trade deficit with the Asian NIEs as a group -- Korea, Taiwan, Hong Kong, and Singapore -- peaked in 1987 at $34.1 billion and has declined a total of 29 percent since then. In 1989 alone, the trade deficit with the Asian NIEs fell $3.9 billion to $24.3 billion, a 14 percent decline from 1988. This compares to an 8 percent decline in the overall U.S. trade deficit from 1988 to 1989. As a proportion of the overall U.S. trade deficit, the deficit with the NIEs fell from 24 percent to 22 percent in the same period.

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 and April 1989 reports that both 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. Subsequently to the October 1988 report, the Treasury Department initiated bilateral negotiations with both Taiwan and Korea on their exchange rate policies, as well as continuing talks with them on their associated macroeconomic and structural policies.

In October 1989, in view of the change in Taiwan's exchange rate system that had occurred during the course of the negotiations, and certain other factors, the Treasury concluded that there were no clear indications that Taiwan was "manipulating" its currency for competitive advantage within the meaning of the legislation. We also indicated, however, that we would continue to monitor Taiwan's exchange rate policy closely, in view of the importance of such policy in furthering the adjustment of Taiwan's large external surpluses. Regarding Korea, the Treasury determined that there were indications of continued exchange rate "manipulation."

Following is a summary of the economic and exchange rate developments in Taiwan and Korea since our October 1989 report.

Taiwan

The appreciation of the NT dollar since 1985 has been a central element in the decline of Taiwan's external trade surpluses. In the past year, the NT dollar's appreciation has stalled, although other factors -- rising wages, inflationary pressures, and reduction of trade barriers -- have contributed to lowering the external surpluses. We expect this adjustment process to continue.

- Exchange Rate Developments

Since the October 1988 report, Taiwan's exchange rate has appreciated by 10 percent, more than that of any other major trading partner. Much of this appreciation occurred in a short period following the April 1989 report. The NT dollar thereupon fluctuated within a narrow range from May 1989 until early March of this year. At that time, the exchange rate depreciated by 1 percent. It has since rebounded slightly and stabilized.

The recent depreciation of the NT dollar was the result of a number of factors. Most importantly, there has been widespread attention in the local foreign exchange market to political uncertainties, especially prior to the March Presidential election. As such, large net capital outflows were reported in the first quarter of this year. The depreciation of the NT dollar was slowed by sizable sales of U.S. dollars by Taiwan's Central Bank.

There is some domestic pressure in Taiwan to depreciate the NT dollar. This view, however, ignores the fact that the recent depreciation was mostly due to speculators seizing on factors that may be short term. In this regard, the Central Bank has rightly noted that depreciation may not reflect Taiwan's still strong economic fundamentals and would have some adverse consequences. For one, the external surpluses, although declining, are still at unsustainably high levels. Real GNP growth also remains strong. Moreover, any potential benefit to exporters from devaluation would likely be negated by a fueling of inflation. Inflation, which has climbed primarily due to the build-up of excess liquidity generated by the large external surpluses, currently may pose the greatest threat to the economy. In addition, depreciation would send the wrong signals to producers by not encouraging the move toward higher value-added goods and weakening the role of domestic demand in economic growth.

o Trade and Economic Developments

In absolute terms, Taiwan's global current account surplus rose 9.5 percent in 1989 to $11.2 billion. As a proportion of GNP, this surplus translated into a decline to 8 percent from 8.5 percent in 1988 and 18.1 percent in 1987. Taiwan's overall trade surplus (cif basis) increased by 27 percent to $14 billion. Our bilateral trade deficit with Taiwan grew 3 percent last year to $13 billion.

The above data include extraordinary purchases of $2.5 billion of gold from the United States by Taiwan's Central Bank in 1988. If these one-time purchases are excluded, the trend in the external accounts continued downward in 1989. For example, the current account surplus fell 15 percent last year, if the 1988 gold purchases are excluded, and the U.S. bilateral trade deficit with Taiwan declined by 14 percent.

These surpluses, whether including or excluding the 1988 gold purchases, are excessively high.

The appreciation of the NT dollar from 1985 to 1989 has had an overall positive impact on the restructuring of the economy. Appreciation has encouraged the production of higher value-added goods and the movement of lower value-added production offshore. In addition, domestic demand has replaced exports as the main source of growth for the economy, with Taiwan's consumers benefiting from years of high savings. At the same time, unemployment, at 1.7 percent, is at an historical low.

Following years of very rapid growth, real GNP growth has been at a more sustainable level since 1988. Last year growth fell slightly to 7.2 percent. Inflation climbed from 1.3 percent in 1988 to 4.4 percent last year. Despite credit tightening measures and capital outflows, inflationary pressures continue to be a serious problem.

As a result of a rise in net capital outflow, Taiwan posted its first overall balance of payments deficit since 1977 last year. This led to a slight fall in foreign exchange reserves to $73 billion, the world's second largest stock at the end of 1989.

In the first three months of this year, Taiwan's overall trade surplus declined by 35 percent over last year to $1.8 billion. In February there was an overall trade deficit of $300 million, although this owed much to special factors including imports delayed during end-January's Chinese New Year holiday and the delivery of a passenger airplane.

According to Taiwan's data, the trade surplus with the United States was down by 23 percent to $1.9 billion in the first quarter of this year. Over the last three months for which U.S. data are available (November 1989 to January 1990), our trade imbalance with Taiwan at $3.4 billion is lower by 18 percent from the same period in the previous year and by 29 percent from the preceding three-month period. If this latest quarter were annualized, it would still lead to a large bilateral trade imbalance of $11.3 billion.

- <u>Exchange Rate System</u>

Taiwan instituted a new exchange rate system at the time of the April 1989 report that significantly reduced the authorities' ability to manipulate the rate. The system allowed for most foreign exchange transactions to be freely determined. Thereafter, Taiwan took a number of measures to further liberalize the system and reduce capital controls.

Currently there is no evidence that the Central Bank has been substantially intervening directly in the market to gain competitive advantage. In fact, as noted earlier, the Central Bank has recently intervened in the market to control downward pressure on the NT dollar.

In the October 1989 report, a number of remaining impediments to liberalization of the Taiwanese financial system were identified. Since the October 1989 report, Taiwan has addressed several of these impediments. The ceiling on a foreign exchange bank's short (oversold) position in spot transactions was doubled in December. Taiwan also raised the limit on foreign liabilities of foreign exchange banks by 30 percent, effective March 10. This should permit banks to increase their foreign exchange activities.

Taiwan also established the Foreign Exchange Development Foundation in late February to operate the interbank foreign exchange market and the new U.S. dollar call market, which reduces the cost of short-term foreign exchange funds. Taiwanese authorities are developing a plan to introduce foreign exchange dealers into Taiwan in one or two years.

In another positive step, the limit on annual foreign exchange inflows was raised to $1 million per entity in November. This limit, however, is still one-fifth the size of permissible capital outflows and impedes market forces. Given that there has been no surge in capital inflows and the NT dollar is stable, there is little justification for not soon raising the limit to at least the level of that for outflows.

Despite the recent relaxation of ceilings on "long" and "short" foreign exchange positions, their existence, plus the method of calculating the foreign exchange positions of a bank, effectively prevents a forward foreign exchange market from functioning. Contrary to international practice, Taiwan shifted from an accrual to a cash basis for calculating a bank's foreign exchange position in 1987 to discourage speculation on an appreciating NT dollar. On a cash basis, forward foreign exchange positions are not calculated. In addition, although the ceilings have not been reached they also discriminate against foreign banks since they are based on local assets. These assets are relatively small since Taiwan has restrictions on foreign banks' operations and branches.

o Assessment

We are encouraged by the fall -- albeit modest -- in Taiwan's external surpluses (adjusted for the 1988 gold purchases) over the past year and the continued liberalization of the exchange rate system, which more accurately reflects market forces. On balance, we are of the view, as expressed in the October 1989 report, that there is no evidence of direct exchange rate manipulation for competitive purposes.

We remain concerned, however, about the persistence of Taiwan's large external surpluses. Moreover, it can be argued that, despite the lack of evidence of direct exchange rate "manipulation," Taiwan's remaining exchange and capital controls -- recent liberalization notwithstanding -- constitute a mechanism for indirect "manipulation" by distorting supply and demand in the market. These factors underscore the importance of continued liberalization of remaining exchange and capital controls and, more generally, of exchange rate policy in contributing in the months ahead to the necessary further reduction of Taiwan's unsustainably large external surpluses.

Korea

The Korean won has depreciated about 6 percent in nominal terms against the U.S. dollar since the won's strongest point in April 1989, but remains some 27 percent stronger against the dollar than it was at the time of the Plaza Agreement in September 1985. In 1988, the won began to strengthen significantly against other G-7 currencies, particularly the yen, resulting in broad appreciation on a trade-weighted basis. These currency movements, aided by wage and other developments, contributed to a substantial decline in Korea's external surpluses in 1989. A further, but smaller, decline is possible this year.

Notwithstanding the decline in Korea's external surpluses in 1989, exchange rate policy continues to have an important role to play in Korea's external adjustment, including the needed further reduction of the trade imbalance between the United States and Korea. In this context, the steady depreciation of the won against the U.S. dollar since April 1989 raises some concerns. Introduction of the new "market average rate" system of exchange rate determination on March 2, 1990, is an important development. The eventual success of this system, however, depends on how it is implemented. In particular, liberalization of pervasive foreign exchange and capital controls is necessary to give greater scope to the forces of supply and demand in the exchange market.

Another development since the October 1989 report was the initiation of Financial Policy Talks between the Ministry of Finance and the Department of the Treasury. These talks provide a possible mechanism for addressing problems that U.S. banks and securities firms face in gaining access to the Korean financial services market. The initial round of these talks was held in late February, but much remains to be done before U.S. banks and securities firms can compete on an equal footing with their Korean counterparts.

o <u>Exchange Market Developments</u>

New Exchange Rate System (MAR)

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

During each business day, the won/dollar inter-bank rate is permitted to fluctuate within a band of ±0.4 percent. Foreign exchange banks, including 53 foreign bank branches, are free to set customer rates within bands of ±0.4 percent for won/dollar telegraphic transfer (TT) transactions and ±0.8 percent for dollar-third currency TT transactions. A ±1.5 percent band is established for cash customer transactions.

Recent Exchange Rate Movements

During the the first five weeks of operation of the MAR system:

-- The won depreciated 1.8 percent against the U.S. dollar in nominal terms and 1 to 4-1/2 percent against most other G-7 currencies and the new Taiwan (NT) dollar.

-- The won appreciated 3.6 percent against the yen, reflecting the weakness of the yen in international markets, offsetting on a trade-weighted basis most of the won's ~~ap~~depreciation against the other currencies.

-- Foreign banks accounted for the majority of transactions in the inter-bank market.

-- The Bank of Korea (BOK) was not a direct participant in the market; and other government-owned banks accounted for a small share of inter-bank activity.

Since late April 1989, when the won reached its strongest point at 665/U.S. dollar, the won has depreciated nearly 6 percent against the U.S. dollar, 2-8 percent against the British pound and Canadian and NT dollars, and 15-16 percent against the German mark, French franc, and Italian lira. In the same period, however, the won has appreciated 13 percent against the yen, reflecting the generalized depreciation of the yen. Thus, on a trade-weighted basis, the won is virtually unchanged from its April 1989 level.

Given these developments, the won's cumulative nominal appreciation against the U.S. dollar since the Plaza Agreement in September 1985 has fallen to 27 percent. For the same period, the won's cumulative nominal appreciation now totals 6 percent against the Canadian dollar and 4 percent against the British pound. The won remains roughly 18-20 percent weaker in nominal terms than the yen, the French franc, Italian lira, and NT dollar, and 26 percent weaker than the German mark in nominal terms than it was in September 1985. Taking these various currency movements into account, the won is estimated to be roughly equal to its September 1985 level in trade-weighted terms.

Recent Changes in Foreign Exchange Controls

The government eased some foreign currency and capital controls as of March 1 to: allow certain Korean companies to purchase and hold up to $10 million in foreign currencies; raise the limits on overseas investment by Korean securities firms from $30 million to $50 million and by Korean insurance and investment and trust companies from $10 million to $30 million; and allow Korean banks for the first time since 1987 to obtain up to $2 billion of long-term capital from foreign banks or from the issuance of bonds in foreign markets.

o <u>Trade and Economic Developments in 1989</u>

GNP Growth

Economic performance in 1989 was weak by Korean standards, but strong by any other. Real GNP grew 6.7 percent. This compares with over 12 percent in each of the three previous years and was the lowest rate since 1981's 5.9 percent. Construction boomed (up 15.4 percent), but manufacturing was weak (up 3.7 percent) and agriculture declined (- 0.7 percent). On the expenditure side, consumption was up 9.5 percent, surpassing for the first time in several decades the rate of growth of GNP. Investment remained healthy, increasing 16.2 percent, including a 12.3-percent increase in plant and equipment. Inflation eased from 7.1 percent to 5.7 percent. Unemployment remained virtually unchanged at 2.6 percent.

Wages increased 21 percent on average for the 30 largest manufacturing companies through end-October, compared with increases of 12 percent and 20 percent in 1987 and 1988, respectively. Labor-management unrest lowered productivity gains to 7.1 percent in 1989, compared with 12 percent in 1987 and 1988, and resulted in production losses equal to an estimated 3.1 percent of GNP.

External Accounts

The current account surplus dropped 64 percent to $5.1 billion (2.5 percent of GNP), compared with $14.2 billion (8.4 percent of GNP) in 1988. The trade surplus also fell -- 61 percent to $4.5 billion, compared with $11.4 billion in 1988. Exports grew only 2.7 percent in value and declined 5.4 percent in volume. Footwear, toys, and especially automobiles accounted for most of the volume decline. Textiles, machinery and electronics, which account for more than half of exports, showed volume growth -- about 7 percent in the latter case. It is estimated that labor-management disputes were responsible for export losses of $1.4 billion. Imports expanded 17.8 percent in value and 14.3 percent in volume. Consumer goods, however, accounted for only 14 percent of the total import growth, with raw materials (54 percent) and capital equipment (32 percent) accounting for the rest of the import growth.

According to U.S. customs data, the U.S. trade deficit with Korea has shown no significant growth since the first quarter of 1988. In 1989, it declined 30 percent to $6.3 billion. This decline reflects a 19 percent increase in U.S. exports to Korea (compared with 39 percent in 1988) and a 3 percent drop in U.S. imports from Korea (compared with a 19 percent increase in 1988).

Korea's gross external debt declined to $29.4 billion in 1989, equal to only 14 percent of GNP, compared with 28 percent of GNP as recently as 1987 and 52 percent of GNP in 1985. Total interest and amortization payments as a ratio of exports of goods and services declined from 14 percent in 1988 to only 10 percent in 1989. Excluding Korea's voluntary prepayments of principal, the 1989 debt service ratio was only 8 percent.

With the increase in international reserves to $15.2 billion (3.2 months' import coverage) and in other foreign assets, Korea's net external debt declined to only $3.0 billion by end-1989.

o <u>Trade and Economic Developments in 1990</u>

Preliminary BOK data indicate that Korea registered a $646 million current account deficit in January-February 1990, compared with an $888 million surplus in the same period in 1989. This included a $722 million trade deficit for the two months ($694 million trade surplus in January-February 1989).

Exports fell 12 percent in value in January but rose 6 percent in February, compared with the same months in 1989, while imports grew 6 percent and 23 percent, respectively. Further trade and current account deficits appear likely in March.

According to U.S. customs data, the U.S. bilateral trade deficit with Korea declined a further 33 percent to $455 million in January 1990 (the latest month for which data are available). This was based on a 23 percent increase in U.S. exports to Korea to $1.2 billion, while U.S. imports from Korea were unchanged at $1.6 billion. For the latest three months (November 1989 to January 1990), the U.S. trade deficit with Korea stands 44 percent lower than it did in the same period in 1988-89.

Wage demands in the first quarter were less than half the level in the first quarter of 1989. The number of strikes is 79 percent lower so far this year. These developments should have a favorable impact on both growth and the external accounts. Indeed, production and export losses are only 3-4 percent of what they were in the first quarter of 1989. On the downside, inflation is creeping up to a 12-13 percent annual rate. The government is forecasting stronger economic performance in the second half of the year, and has not changed its projections for 6-7 percent real GNP growth and a $2 billion current account surplus for 1990 as a whole. The government also expects that Korea will be a net international creditor by end-1990.

The recent merger of three leading political parties to create the new, ruling Democratic Liberal Party and the subsequent changes in leadership at the economic ministries have created public expectations in Korea that "growth-first" measures to stimulate the economy, and exports in particular, will be reemphasized. It is also expected that policies designed to improve social welfare and income and wealth distribution, while not neglected, will receive correspondingly less attention.

The new economic policy package announced on April 4, which builds on measures adopted in December 1989, bears out these expectations. To stimulate investment and exports, the package includes:

-- Subsidized interest rates, higher credit ceilings, and tax incentives for investment and R&D in manufacturing and, particularly, exports; lower corporate income tax rates for manufacturing, as compared with services; streamlined government approval procedures for new manufacturing/export investments; and funds for technology development and training, especially aimed at small and medium-sized enterprises.

Other recent policy measures include:

-- Indefinite postponement of introduction of the requirement to use real names in conducting financial transactions.

-- Higher taxes, tighter credit, and possible economic and social sanctions to discourage "professional" or "habitual" real estate speculators.

-- Tax reform to ease the burden on low-income wage earners along with other measures to increase incentives for construction of rental or low-income housing, employee education, and other benefit programs.

-- Wage guidelines and controls and reductions in charges on public utilities.

-- Tight restrictions on consumer credit, higher excise taxes, income tax assessments based on observed "standard of living" rather than reported income, and restraints on overseas travel expenditures (December 1989 policy package).

o <u>Financial Policy Talks</u>

Korea's impressive economic growth in recent years has not been matched by comparable development and liberalization of its financial system. Despite some steps to liberalize controls and provide national treatment to U.S. and other foreign financial institutions, the system remains characterized by pervasive government intervention in financial intermediation and significant constraints on the ability of U.S. and other foreign financial institutions to compete on an equal footing with Korean institutions.

With these problems in mind, the Treasury Department and the Korean Ministry of Finance initiated a new series of Financial Policy Talks in late February. These talks will provide a mechanism for addressing specific market access problems that U.S. banks and securities firms face in doing business in Korea and also allow a dialogue on the need for broader liberalization of Korea's financial, capital, and exchange markets.

In the first round, the Korean government gave positive signs of its willingness to address some specific issues, but necessary follow-up actions remain to be taken. We will be continuing these talks in the period ahead. The October 1990 report on International Economic and Exchange Rate Policy and the December 1990 report to the Congress on Foreign Treatment of U.S. Financial Institutions provide target dates for achieving substantial progress on these matters.

o Assessment

Korea has achieved a large and welcome reduction in its current account surplus, from 8.4 percent of GNP ($14.2 billion) in 1988 to 2.5 percent of GNP ($5.1 billion) in 1989. Also, the U.S. bilateral trade deficit with Korea declined by 30 percent in 1989 to $6.3 billion. These imbalances, although sharply reduced, remain large and there is room for further reductions. In this regard, it is noteworthy that Korea's current account registered a deficit for the first two months of this year, although a surplus is expected for the year.

The won has depreciated 5 percent against the dollar since the October report, and by 1.8 percent since the introduction of the new exchange rate system on March 2. The depreciation against the dollar in the latter period, however, appears largely attributable to Korea's trade and current account deficits in the first two months of this year and capital outflows associated with concerns about the possible introduction of the "real name" financial system (now indefinitely postponed). Moreover, on a trade-weighted basis, the won's value has not significantly changed in this period. There is no evidence of the government conducting transactions in the inter-bank market for the purpose of directly influencing the exchange rate.

In view of these developments in Korea's external accounts and in its exchange markets, there are no clear indications at this time that the Korean won continues to be directly "manipulated," within the meaning of the legislation, by the authorities to gain unfair competitive advantage.

Nonetheless, exchange rate policy continues to have an important role to play in fostering external adjustment. Introduction of the "market average rate" system of exchange rate determination was a positive step forward. The real significance of this step, however, will depend on the government's willingness to ease the pervasive controls on capital flows and the types and amounts of permissible foreign currency transactions that give it effective tools for indirectly "manipulating" supply and demand in the currency market and, thus, the exchange rate itself. In this regard, the recent liberalization of controls on certain foreign currency transactions by large Korean corporations and on overseas investments of Korean financial institutions should increase pressure for the won to depreciate. Controls on capital inflows should be liberalized to offset this effect. It is not clear, however, that the net impact of the allowable $2 billion in foreign borrowing by Korean banks will accomplish this. If the proceeds of these borrowings are on-lent in foreign currencies for the overseas expenses of Korean corporations, there may be little effect on the exchange rate.

Despite the lack of evidence of direct government "manipulation" of the exchange rate via transactions in the market, we remain concerned about the won's nominal depreciation against the U.S. dollar since April 1989 (although, in trade-weighted terms, there appears to be little change). By raising the cost of Korea's dollar-denominated imports, including its oil imports, depreciation will add to inflation, the increase in which is already a concern to policymakers. The resulting loss of real purchasing power could well lead to higher wage demands over the long-term, offsetting any beneficial short-term impact of depreciation on competitiveness. Moreover, as the United States is Korea's largest export market, depreciation against the dollar is likely to encourage the inefficient production of certain lines of exports in which Korea has already been losing competitiveness relative to lower wage-cost Asian competitors.

The recent policy measures signal greater government intervention in the economy and add to our concern. While we understand the government's concern about the sharpness of the declines in Korea's external surpluses in 1989, this reflects largely the long delay in beginning the adjustment process (the won did not begin to appreciate significantly against the dollar and, especially, the major non-dollar currencies until 1988). On balance, the new policies appear likely to delay the adjustment process. Aimed at increasing exports and suppressing domestic demand, the new measures may reinforce Korea's dependence upon exports as a source of growth and jeopardize the encouraging shift that appeared to have begun in 1989 toward greater reliance upon domestic demand as a source of growth.

In the period ahead, we will continue to monitor Korea's trade developments and the operation of the new exchange rate determination system closely. In the Financial Policy Talks, we will continue to encourage liberalization of Korea's financial, capital, and exchange markets as well as seek improved treatment for U.S. financial institutions.

PART VI: CONCLUSION

This report has provided an update of developments since October 1989, when the second annual report on international economic and exchange rate policies was submitted to Congress.

Global economic performance has remained favorable since the October 1989 report. The economic expansion in the industrial countries has been sustained for eight consecutive years. Economic growth is slowing in several countries, but to more sustainable levels. Strong investment is providing a major stimulus to the G-7 economies, and the prospects for overall growth remain good. Inflation remains contained, reflecting the vigilance of authorities and the subsiding of several temporary factors, last year, which placed upward pressures on inflation rates.

Substantial reductions in external imbalances have been achieved, particularly in Japan and the United States. The U.S. trade deficit fell further in 1989, by nearly $14 billion to $113 billion, and the current account deficit fell by some $21 billion to $106 billion. The pace of global external adjustment has slowed, however. Despite our view that positive factors are at work in encouraging medium term adjustment and that these factors are not captured by conventional models, further improvement in the U.S. current account position in 1990 is likely at best to be modest. Furthermore, the possibility of deterioration in the current account next year cannot be excluded.

The economic policy coordination process has contributed importantly to the favorable performance of the world economy in the current expansion. Continued economic policy coordination, including cooperation in exchange markets, will be essential in assuring that the profound changes underway in the world economy -- most notably, the changes in Eastern European political and economic life and developments in global financial markets -- are managed in an orderly manner that contributes to sustained growth, low inflation, and reduced external imbalances.

- Both surplus and deficit countries have a shared responsibility in this regard. Surplus countries must sustain non-inflationary growth of domestic demand. Deficit countries should further reduce budget deficits and increase private savings.

- All countries should promote appropriate structural reforms.

-- The depreciation of the Japanese yen has occurred in the context of a significant adjustment in Japanese equity prices as well as a correction in other Japanese asset values. This depreciation is a matter of concern, with undesirable consequences for the adjustment process. The G-7 will keep these developments under review.

-- The restructuring of Eastern European economies towards a market basis and the reunification of the German economies should contribute to improved global growth and to a reduction of external imbalances. This will be a most welcome development, especially in light of Germany's massive and growing external surpluses.

Other economies have a clear and complementary responsibility in promoting sustained non-inflationary world growth and adjustment of external imbalances. In the October 1988 and April 1989 reports on International Economic and Exchange Rate Policy, it was determined 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 the October 1989 report, it was concluded that there were no clear indications Taiwan was "manipulating" its currency within the meaning of the legislation, but that there were indications of continued exchange rate "manipulation" by Korea.

Taiwan, last April, instituted an exchange rate system that allowed for most foreign exchange transactions to be freely determined. Since last October, a number of impediments to liberalization of the Taiwanese financial system have been addressed.

The appreciation of the NT dollar since 1985 has been a central element in the decline of Taiwan's external surpluses in recent years. Last year, however, Taiwan's global current account surplus rose by 9.5 percent to $11.2 billion and as a share of GNP it declined slightly to 8 percent. The U.S. bilateral deficit with Taiwan also rose in 1989. The rise in Taiwan's external surpluses in 1989 in part reflected the effects of extraordinary purchases of $2.5 billion of gold from the United States in 1988. Excluding these one-time purchases, Taiwan's current account surplus fell 15 percent and our bilateral deficit with Taiwan fell 14 percent. Nonetheless, these surpluses, whether including or excluding the 1988 gold purchases, remain excessively high.

Between May of 1989 and early March of this year, the NT dollar fluctuated narrowly against the U.S. dollar. Subsequently, it depreciated by 1 percent, before rebounding slightly. The decline reflected a number of factors, including significant capital outflows in response to continuing political uncertainties, and was resisted by the Central Bank. There is no evidence that the Central Bank has been intervening directly in the market to gain unfair competitive advantage. Moreover, the Central Bank has rightly noted that NT dollar depreciation does not reflect Taiwan's still strong economic fundamentals and would have some adverse consequences.

On balance, we remain of the view, as expressed in the October 1989 report, that there is no evidence of exchange rate "manipulation" by Taiwan. There is still reason, however, to be concerned about Taiwan's unsustainably large external surpluses. The adjustment process must continue. Liberalization of remaining exchange and capital controls and, more broadly, exchange rate adjustment need to play a role in this process. The Treasury Department will continue to monitor the situation carefully.

Korea has achieved a large and welcome reduction in its current account surplus, from 8.4 percent of GNP ($14.2 billion) in 1988 to 2.5 percent of GNP ($5.1 billion) in 1989. Also, the U.S. bilateral trade deficit with Korea declined by 30 percent in 1989 to $6.3 billion. Korea's current account registered a deficit for the first two months of this year, although a surplus is expected for the year as a whole.

Korea introduced a new "market average rate" system of exchange rate determination on March 2. Since this system's introduction, there is no evidence that the government is conducting transactions in the inter-bank market in order to directly influence the exchange rate.

The won has depreciated 5 percent since the October 1989 report, and by 1.8 percent against the dollar since the introduction of the new exchange rate system. But the depreciation in the latter period appears largely attributable to Korea's trade and current account deficits in the first two months of this year and capital outflows associated with concerns about the possible introduction of the "real name" financial system (now indefinitely postponed). In trade-weighted terms, the won appears to have changed little since April 1989.

In view of these developments in Korea's external accounts and exchange market, there are no clear indications at this time that the Korean won continues to be "manipulated," within the meaning of the legislation, by the authorities to gain unfair competitive advantage.

Nonetheless, exchange rate policy continues to have an important role to play in fostering external adjustment. In particular, the government needs to allow supply and demand to function more freely in the exchange market. The government's pervasive controls on capital flows and the types and amounts of permissible foreign currency transactions give it effective tools for indirectly influencing supply and demand in the currency market and, thus, the exchange rate itself. Thus, these controls should be rapidly liberalized. The recent easing of controls on certain foreign currency transactions by large Korean corporations and on overseas investments of Korean financial institutions, however, could increase pressure for the won to depreciate. There should be a corresponding liberalization of controls on capital inflows to offset this effect.

Although there is a lack of evidence of direct government "manipulation" of the exchange rate, we remain concerned about the won's depreciation. Recent policy measures, aimed at increasing exports and suppressing domestic demand, add to our concerns. They are likely to delay the adjustment process, jeopardizing the encouraging shift that appeared to have began in 1989 toward greater reliance upon domestic demand as a source of growth.

In the period ahead, we will continue to monitor Korea's trade developments and the operation of the new exchange rate determination system closely. In the Financial Policy Talks, we will continue to encourage liberalization of Korea's financial, capital, and exchange markets as well as seek improved treatment for U.S. financial institutions.

APPENDIX

TABLES

TABLE 1

Economic Performance of Major Industrial Countries

	GNP 1/			Domestic Demand 1/		
	1988	1989	1990	1988	1989	1990
U.S.	4.4	3.0	2.4	3.3	2.4	2.2
Japan	5.7	4.9	4.6	7.6	5.7	4.8
Germany	3.6	4.0	3.2	3.7	2.8	3.1
France	3.4	3.4	3.1	3.9	3.2	3.2
U.K.	4.5	2.3	1.3	7.4	3.9	0.0
Italy	4.2	3.2	3.0	4.3	3.7	3.4
Canada	5.0	2.9	1.6	5.8	5.2	1.6
G-7 2/	4.5	3.4	2.8	4.6	3.4	2.7

	Inflation 3/			Current Account 4/		
	1988	1989	1990	1988	1989	1990
U.S.	4.1	4.8	4.0	-2.6	-2.0	-2.0
Japan	0.7	2.3	1.7	2.8	2.0	2.0
Germany	1.3	2.8	2.5	4.0	4.4	4.9
France	2.7	3.5	3.1	-0.4	-0.4	-0.3
U.K.	4.9	7.9	7.2	-3.1	-4.0	-3.1
Italy	5.0	6.3	5.5	-0.6	-1.1	-1.0
Canada	4.0	5.1	4.9	-1.7	-2.9	-2.7
G-7 2/	3.3	4.5	3.8			

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* Data for 1988 and 1989: national sources and International Monetary Fund. Data for 1990: For U.S. - Administration projections; for other countries - International Monetary Fund, *World Economic Outlook* (forthcoming).

1/ Annual average rates in real terms.

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

3/ Consumer prices; annual average.

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

Table 2

SUMMARY OF U.S. TRADE AND CURRENT ACCOUNT DEVELOPMENTS
($ billion, seasonally adjusted)

	YEARS			1988				1989			
	1987	1988	1989	QI	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Exports	250.266	319.251	361.872	76.447	78.471	80.604	83.729	87.783	91.284	90.691	92.114
Agricultural	29.547	38.142	41.433	9.021	9.405	9.927	9.789	10.777	10.879	9.683	10.099
NonAgricultural	220.719	281.109	320.439	67.426	69.066	70.677	73.940	77.006	80.410	81.008	82.015
Imports	-409.766	-446.466	-475.120	-109.893	-109.882	-110.943	-115.748	-116.138	-118.813	-119.249	-120.920
Petroleum & Prods	-42.944	-39.309	-50.250	-10.068	-10.248	-9.775	-9.218	-10.845	-13.424	-13.018	-12.963
NonPetroleum	-366.822	-407.157	-424.870	-99.825	-99.634	-101.168	-106.530	-105.293	-105.389	-106.231	-107.957
TRADE BALANCE	-159.500	-127.215	-113.248	-33.446	-31.411	-30.339	-32.019	-28.355	-27.529	-28.558	-28.806
Net Investment Income	22.284	2.229	1.029	2.795	-2.465	-2.590	4.489	-2.484	-6.104	2.860	6.757
Direct Investment	45.256	31.517	36.164	8.490	4.927	5.567	12.533	5.984	3.070	11.647	15.463
(of which: Capital Gains/Losses on US Investments Abroad)	16.174	-0.144	-.394	0.858	-2.487	-2.585	4.069	-3.512	-4.626	3.182	4.562
Portfolio Investment	-22.972	-29.288	-35.135	-5.695	-7.392	-8.157	-8.044	-8.468	-9.174	-8.787	-8.706
Net Other Services	7.731	13.096	20.616	1.969	3.291	3.964	3.872	3.934	4.461	6.271	5.950
Military	-2.857	-4.607	-5.662	-0.964	-1.033	-1.006	-1.604	-1.498	-1.518	-1.175	-1.471
Travel & Fares	-6.252	-1.923	1.176	-1.496	-0.493	-0.039	0.105	-.229	.095	.766	.544
Other Transport	-1.073	-0.711	-.384	-0.358	-0.226	-0.116	-0.011	-.057	.007	-.249	-.085
Fee, Royals & Misc	17.913	20.337	25.486	4.787	5.043	5.125	5.382	5.718	5.877	6.929	6.962
Unilat Transfers	-14.213	-14.657	-14.277	-3.364	-2.899	-3.376	-5.018	-3.487	-2.829	-3.485	-4.476
Remits & Pensions	-4.063	-4.280	-4.029	-1.131	-0.971	-1.088	-1.090	-1.147	-.972	-.975	-.935
Government Grants	-10.150	-10.377	-10.248	-2.233	-1.928	-2.288	-3.928	-2.340	-1.857	-2.510	-3.541
NET INVISIBLES	15.800	.667	7.378	1.400	-2.074	-2.001	3.342	-2.036	-4.470	5.649	8.235
CURRENT ACCOUNT BALANCE	-143.700	-126.548	-105.870	-32.046	-33.485	-32.340	-28.677	-30.391	-31.999	-22.909	-20.571

Source: SURVEY OF CURRENT BUSINESS, March 1990
Details may not sum to totals due to rounding.

4/17/90

Table 3

SUMMARY OF U.S. CAPITAL FLOWS
Inflows(+) Outflows (-) Billions

	YEARS 1989	1988	1988 QI	Q2	Q3	Q4	1989 Q1	Q2	Q3	Q4
U.S. Reserve Assets (incr(-) decr (+))	-25.293	-3.566	1.503	0.039	-7.380	2.272	-4.000	-12.095	-5.996	-3.202
Other U.S. Govt Assets	1.036	2.999	-1.673	-0.829	2.001	3.499	0.869	-.254	.543	-.121
Foreign Official Assets:	7.369	38.882	24.631	5.895	-2.234	10.589	7.478	-5.201	12.097	-7.005
Industrial	-1.398	30.215	20.689	7.238	-3.106	5.393	1.371	-7.219	6.653	-2.203
OPEC	10.680	-3.109	-1.547	-1.776	-0.459	0.672	7.143	.433	4.515	-1.411
Other	-1.913	11.776	5.489	0.433	1.331	4.524	-1.036	1.585	.929	-3.391
Banks, net:	10.739	14.351	-1.871	17.853	-2.938	1.307	-8.871	5.816	4.477	9.317
Claims	-47.244	-54.481	15.266	-12.602	-26.229	-30.916	-22.132	27.238	-20.700	-31.650
Liabilities	57.983	68.832	-17.137	30.455	23.291	32.223	13.261	-21.422	25.177	40.967
Securities, net	43.220	36.230	2.689	14.937	9.271	9.334	14.057	4.476	11.106	13.581
Foreign Securities	-22.551	-7.846	-4.539	1.333	-1.592	-3.047	-2.568	-5.737	-10.392	-3.854
U.S. Treas. Securities	29.411	20.144	5.928	5.458	3.422	5.336	8.590	2.252	12.714	5.855
Other U.S. Securities	36.360	23.932	1.300	8.146	7.441	7.045	8.035	7.961	8.784	11.580
U.S. Dir. Invest. Abroad	-28.290	-15.017	-5.476	.612	-4.899	-5.254	-4.962	-6.613	-8.642	-8.073
Reinvested Earnings	-21.437	-15.170	-3.901	-2.721	-4.489	-4.058	-3.856	-3.619	-9.575	-4.387
Equity & Inter-Co. Debt	-6.853	.154	-1.575	3.333	-.409	-1.196	-1.106	-2.994	.933	-3.686
For. Dir. Invest. in U.S.	61.262	58.436	9.616	13.885	11.896	23.038	19.161	13.267	12.436	16.397
Reinvested earnings	3.363	6.560	1.774	1.357	2.083	1.347	0.208	1.807	1.189	.159
Equity & Inter-Co. Debt	57.898	51.875	7.842	12.528	9.814	21.692	18.953	11.460	11.247	16.238
Other U.S. Corp.,net	.921	4.874	1.500	-6.502	2.605	7.271	4.687	-3.315	-.451	-
Claims	.608	-1.684	-0.065	-6.443	0.255	4.569	1.835	-2.954	1.727	-
Liabilities	.313	6.558	1.565	-0.059	2.350	2.702	2.852	-.361	-2.178	-
NET CAPITAL FLOWS	70.964	137.189	30.919	45.891	8.324	52.056	28.419	-3.919	25.570	20.894
Statistical Discrepancy	34.914	-10.641	-3.364	-12.015	28.603	-23.865	-2.425	35.807	2.285	-.753
TOTAL	105.878	126.548	27.556	33.875	36.926	28.191	25.994	31.888	27.855	20.141

Sources: SURVEY OF CURRENT BUSINESS, March 1990.

Table 4

Measurements of Dollar Movements (for key dates)
Versus G-7 Currencies
Percent dollar appreciation (+) or depreciation (-)

As of April 10, 1990

Value of the Dollar in Terms of:	Since Dollar Peak 26-Feb-85 to date	Since Plaza Accord 20-Sep-85 to date	Dollar Lows 31-Dec-87 to date	Over Last Year 10-Apr-89 to date	Since Previous Report 13-Oct-89 to date
Japanese yen	-39.6	-34.8	+30.0	+19.0	+9.6
German mark	-51.3	-41.4	+7.1	-9.9	-11.1
British sterling	-36.2	-17.2	+14.5	+3.7	-4.9
French franc	-46.5	-35.5	+6.1	-10.4	-12.0
Italian lira	-42.7	-36.0	+6.4	-9.9	-10.6
Canadian dollar	-17.1	-15.6	-10.6	-1.8	-1.0

Source: New York 9:00 a.m. exchange rates

TABLE 5

ASIAN NIES: TRADE AND CURRENCY CHANGES

Cumulative Change against US$ as of April 10, 1990

from:	(Plaza) 9/20/85	end-86	end-87	(Report) 10/14/88	end-89	Rate on 4/10/90
HK$	0.21%	-0.11%	-0.50%	0.19%	0.08%	HK$ 7.80
Won	26.59%	21.89%	12.13%	0.52%	-3.95%	W 706.60
Singapore$	17.16%	15.49%	6.15%	7.57%	1.12%	S$ 1.88
NT$	54.19%	35.08%	8.64%	9.97%	-0.44%	NT$ 26.28
Yen	53.69%	1.29%	-21.55%	-19.76%	-8.83%	Y 157.56
DM	72.20%	15.71%	-4.73%	7.66%	0.90%	DM 1.68

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

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

	1985	1986	1987	1988	1989
Hong Kong	-5.6	-5.9	-5.9	-4.6	-3.4
Korea	-4.1	-6.4	-8.9	-8.9	-6.3
Singapore	-0.8	-1.3	-2.1	-2.2	-1.6
Taiwan	-11.7	-14.3	-17.2	-12.6	-13.0
TOTAL NIEs	-22.1	-27.8	-34.1	-28.2	-24.3
Total U.S. Trade Balance	-132.1	-152.7	-152.1	-118.5	-108.6
NIEs as % Total U.S. Trade Bal.	17%	18%	22%	24%	22%

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