DEPARTMENT OF THE TREASURY

REPORT TO THE CONGRESS

ON

INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICY

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TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Part</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Part I</td>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td>Part II</td>
<td>Economic Policy Coordination and the Economic Situation in the Industrial Countries</td>
<td>2</td>
</tr>
<tr>
<td>Part III</td>
<td>Developments in Foreign Exchange Markets</td>
<td>8</td>
</tr>
<tr>
<td>Part IV</td>
<td>U.S. Balance of Payments and Associated Issues</td>
<td>11</td>
</tr>
<tr>
<td>Part V</td>
<td>Asian Newly Industrialized Economies (NIES) and China</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>- Korea</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>- Taiwan</td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>- China</td>
<td>30</td>
</tr>
<tr>
<td>Part VI</td>
<td>Conclusion</td>
<td>36</td>
</tr>
<tr>
<td>Appendix:</td>
<td>Tables and Charts</td>
<td>41</td>
</tr>
</tbody>
</table>
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 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 the Secretary to provide a written update of developments six months after the initial report. This is the fifth annual report submitted to Congress.

Part II of this report reviews the economic situation in the industrial countries and efforts by major countries to coordinate economic policies. 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 assesses issues related to the U.S. economic and balance of payments situation. Part V, prepared pursuant to Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, considers whether countries manipulate the rate of exchange between their currencies and the U.S. dollar within the meaning of the legislation. In this connection, a status report on developments in Taiwan, Korea, and China is provided. The final part provides conclusions on the principal issues discussed in the report.
PART II: ECONOMIC POLICY COORDINATION
AND THE ECONOMIC SITUATION IN THE INDUSTRIAL COUNTRIES

The increased integration of the world economy has significantly reduced the economic independence of even the largest economies and reaffirmed the importance of a strong economic policy coordination process. A sound world economy requires that the major countries work closely to formulate compatible policies necessary for sustained growth with low inflation, sustainable external imbalances, and greater stability of exchange markets.

The coordination process was intensified in the mid-1980s in response to divergent economic performances among the major economies which had resulted in growing external imbalances, substantial dislocations in the U.S. manufacturing sector, and rising protectionist pressures. Beginning with the 1985 Plaza Agreement, the major countries agreed on policy actions to address these problems and to facilitate balance of payments adjustment and economic growth.

The broad agreement on policy directions achieved by the G-7 countries through the late 1980s contributed to the longest peacetime expansion in the post-war period, reductions in external imbalances, and increased stability in exchange markets.

In the 1990s, however, divergent economic conditions have emerged and the historic changes in East Europe, the former Soviet Union, and elsewhere resulted in a loss of consensus on economic policy priorities. In the United States, declining price pressures and concern over rising unemployment led authorities to ease monetary policy and lower interest rates. At the same time, Germany's mounting unification costs coupled with the Bundesbank's adherence to price stability goals led to a tight monetary policy and higher interest rates. Under the fixed exchange rates of the European Monetary System (EMS), high German interest rates were transmitted throughout Europe -- at a time of slowing growth.

The resulting disparity in interest rates in Europe and the United States contributed to strong exchange rate pressures. These pressures were especially acute in Europe where authorities struggled to maintain fixed exchange rates despite divergent economic conditions.

Thus, the challenges confronting G-7 policymakers have been to 1) achieve a new policy consensus oriented toward growth and 2) strengthen the coordination process to respond to changes in the international economy. Below is a description of the current economic situation and prospects in the major countries and the G-7's response.
Growth

The G-7 economies are still experiencing slow aggregate growth, but considerable disparities in economic performance remain. In the aggregate, real GDP/GNP is expected by the IMF in its October forecasts to increase about 1.7 percent in 1992 on a year-over-year basis. This would be an improvement over last year's performance -- when real growth was only 0.6 percent -- but is, nonetheless, substandard compared with the long expansion following the 1982 recession. (See Table 1 for detailed IMF projections.)

Recent slow growth appears to be related to imbalances which arose during the economic expansion of the 1980s. During this period, asset prices in some countries escalated to inappropriate levels; corporate and household debt rose to uncomfortable heights; and stocks of some real assets increased beyond current need. The adjustment process necessary to reduce these imbalances has slowed recovery from recession in the United States, Canada, and the United Kingdom. In Japan and Germany, where growth had not initially faltered, weakness is now clearly evident. In addition, developments in European currency markets and questions surrounding the Maastricht Treaty have increased economic uncertainties in Europe and may have contributed to weaker growth.

For 1993, the IMF has projected 3.0 percent aggregate G-7 growth. However, this forecast is subject to considerable uncertainty, and substantial downside risk exists. Latest data suggest, for example, that consumer confidence remains weak, industrial output is below earlier peaks, and business investment is sluggish. Consequently, a number of forecasters, including the international financial institutions, have been revising downward their projections for next year.

Growth in 1992 is projected by the Fund to be strongest in France, Canada, Japan, and the United States. France has been able to maintain modest growth in 1992 (projected at 2.2 percent), reflecting exports to other EC countries, despite high interest rates; Canada's economy is projected to achieve nearly comparable results (2.1 percent growth) by a recovery in interest sensitive construction and by exporting to the growing U.S. economy.

Growth in Japan is likely to be very disappointing by historical standards (around 2.0 percent in 1992 according to the IMF) because domestic demand has been restrained by the adverse effects on consumption and investment of falling real estate and equity prices, by previous very high levels of private investment, and by contractionary fiscal policies. Mitigating the effect of these policies is Japan's success in exporting to rapidly growing Asian markets. The recently announced fiscal stimulus program should help to strengthen the economy, although the effects of the program may not be visible until next year. Given the hindrances
to strong growth, the IMF's October projection of 3.8 percent growth for 1993 appears quite optimistic.

The greatest uncertainties are in Europe. Germany's economy faltered in the second quarter after an aberrantly strong first quarter. While consumption may respond positively to the removal of the income tax surcharge last July, and some types of investment -- especially in eastern Germany -- should show moderate growth, growth in 1992 is projected by the IMF to reach 1.8 percent for Germany as a whole. The Fund's forecast of 2.6 percent growth for 1993 assumes that current obstacles to strong recovery -- particularly high real interest rates -- will be overcome.

The United Kingdom apparently remains in recession; lower interest rates and the September devaluation may not have much impact until next year, and growth for 1992 is expected to be negative (-0.8 percent). France should experience modest growth in 1993, but this economy will have to overcome the improved competitiveness of goods produced in the U.K., Italian, and Spanish economies, as well as the adverse effect of high domestic interest rates.

Price Trends

Inflation has been declining in most G-7 countries, and should continue to slow next year. The IMF projects a decline in aggregate G-7 consumer price inflation from 4.3 percent in 1991 to 3.1 percent in 1992 and 3.2 percent in 1993. These will be the best aggregate inflation rates since the late 1960s (excluding the 1986-88 period following the collapse of world petroleum prices), and indicate a major improvement in economic performance after the high inflation of the 1970s. Last year, France registered the lowest inflation rate, with an increase of just 3.1 percent in consumer prices. This year, Canada is likely to be most successful in approaching practical price stability by limiting inflation to a rate of only 1.6 percent.

The IMF projects consumer price inflation in the United States of 3.1 percent in both 1992 and 1993, about the same as the Mid-Session Budget Review estimates. Among other factors, availability of manufacturing capacity, reasonably good productivity growth, and low raw material prices have allowed output to grow while price performance improves. Alone among the G-7 countries, Germany will record higher year-over-year inflation in 1992 than in 1991, mainly because of the impact of consumption tax increases that went into effect in July 1991. Once the influence of these measures had been eliminated from the CPI (in July 1992), inflation fell. Favorable influences on Germany's medium-term outlook include the downward impact on import prices of recent DM appreciation and a more moderate pattern of wage settlements.
The United Kingdom and Italy have both been successful in reducing inflation thus far in 1992 compared with 1991. Inflation in the United Kingdom is expected to fall on a year-over-year basis from 5.9 percent in 1991 to 3.8 percent in 1992. Similarly, inflation in Italy is expected to fall from 6.3 percent in 1991 to 5.6 percent in 1992. The IMF expects further small improvements in 1993, but the recent depreciation of the pound and lira against the DM may increase import prices and limit further progress on the inflation front. Inflation in Japan is expected to be a bit more than a 2 percent rate in 1992 and 1993. Wages have been rising slowly and land prices have been falling. Appreciation of the yen has also had the effect of reducing the prices of imported goods.

External Account Developments

The most important recent development in the external accounts of G-7 countries is the continuing sharp rise in Japan's trade and current account surpluses (to a current account surplus of $110 billion for 1992 according to IMF projections). In the United States there has been some leveling off in the reduction of the current account deficit. For other G-7 countries, nothing dramatic is anticipated. Germany's deficit should rise somewhat to about $22 billion in 1992 and then fall by a substantial amount to about $9 billion in 1993. The United Kingdom's deficit is expected to deteriorate from $11 billion in 1991 to $19 billion in both 1992 and 1993, while the IMF forecast shows deterioration in Italy's current account deficit to $25 billion in 1992 and $33 billion in 1993. However, the recent depreciations of the pound and lira vis-à-vis the DM could alter these projections.

In 1991, the U.S. current account showed a deficit of $3.7 billion, down $87 billion from the 1990 result. Only about $45 billion of the decline reflected ordinary economic factors; the remainder (about $42 billion) reflected Desert Storm-related transfers. Without the transfers, the 1991 deficit would have been about $46 billion. The merchandise trade and current account deficits are likely to deteriorate this year, as higher growth leads to a pickup in imports, and disappointing growth in Europe and Japan limits export expansion.

Japan's current account surplus declined during the late 1980s, but this trend stopped in 1990, and the Japanese current account surplus rose once again to nearly $73 billion in 1991. The IMF projects that the surplus will reach about $110 billion in 1992. About 80 percent of the projected increase is due to a growing trade surplus. Imports have not changed much in yen terms since 1989, while exports, particularly to countries in Asia, have grown rapidly. Total Japanese exports are expected to increase nearly $25 billion in 1992. The surplus is not expected to change much in 1993.
Between 1990 and 1991, there was strong shift in Germany's external accounts from a current account surplus of $47 billion to a deficit of $20 billion. This shift reflected the impact of unification between an advanced industrial area in the west and a much less advanced developing region (the former GDR) in the east. The balance of payments consequences occurred in two phases. Initially, exports of both east and west Germany fell, and imports of both areas rose. The main factors were a diversion to the eastern area of west German goods that might have been exported; the collapse of east German exports to COMECON; and the substantial transfers by west Germany that allowed east Germans to finance a consumption boom. This situation persisted until the second quarter of 1991, when policy changes were made that cut the growth of imports and mildly stimulated exports. These policies are still largely in place, and should produce a current account deficit of about $22 billion in 1992 and a deficit of $9 billion in 1993.

The G-7 Response

Since 1991, the overriding U.S. priority in the G-7 has been to build a consensus around a growth-oriented strategy designed to assure a strong recovery, create jobs, and provide a supportive global economic environment for the reforming countries of East Europe, the former Soviet Union, and elsewhere.

U.S. efforts have been complicated, however, by divergent economic conditions among the major economies. When the economic slowdown took hold in the U.S., Canada, and the U.K. in the second half of 1990, strong growth rates prevailed in Germany and Japan. Cyclical differences in economic performance gave way to broader policy divergences as high German budget deficits associated with unification costs and the Bundesbank's tight monetary policies resulted in steadily rising German interest rates. The commitment of other EC countries to the EMS required them to pursue high interest rates in order to maintain fixed exchange rates -- despite weakening economic conditions.

G-7 countries began to coalesce around the U.S. growth strategy, however, as the downturn in economic growth persisted and prospects for a strong recovery appeared increasingly uncertain. At the Munich Summit, a new consensus on the priority of growth was endorsed by Heads of State, who expressed particular concern over the hardship created by unemployment and pledged to adopt policies aimed at creating jobs and growth.

The new G-7 consensus was reflected in Munich Summit guidelines committing countries to pursue sound fiscal and monetary policies in order to create the scope for lower interest rates and support for the upturn without rekindling inflation.

There was also agreement to reduce structural rigidities that posed obstacles to private initiative and employment creation. In
this regard, Summit participants agreed on the importance of an early conclusion to a successful Uruguay Round in order to reinforce growth in the major economies as well as to support reforming countries elsewhere in the world.

Actions have been taken to implement the new G-7 consensus and strengthen the economic recovery. Japan has announced the largest fiscal stimulus package in its history and Germany has cut interest rates for the first time in five years. Reduced price pressures and lower interest rates in a number of countries have established the basis for a pick-up in investment and growth.

G-7 measures to increase growth occurred amid turmoil in European exchange markets and disruptions in the EMS (see Part III). At their September meeting, G-7 Ministers and Governors expressed concern over the volatility in exchange markets and agreed that recent measures to increase growth would foster greater stability in exchange markets.

Recent events have demonstrated anew the consequences of incompatible and inconsistent policies in an integrated world economy with global financial markets. The fundamental premise of the G-7 process has been reaffirmed, but there must be a continued willingness to consider measures to improve economic policy coordination in order to respond to the significant changes in the world economy.

Global capital markets have undergone particularly significant change. The speed and size of international capital flows have grown enormously and the channels for their transmission have increased in complexity with the development of new instruments and technologies. As a result, foreign exchange transactions have increased substantially -- to nearly $1 trillion daily according to some estimates.

At the U.S. initiative, the Group of 10 is now considering the implications of developments in international capital markets for the exchange rate system and economic policy coordination. This analysis will assist G-7 Finance Ministers leading up to the Tokyo Summit as they examine methods of cooperation that will permit the international monetary system to adapt to changing circumstances while ensuring internationally responsible policies.
PART III: DEVELOPMENTS IN FOREIGN EXCHANGE MARKETS

Overview

Over the past year (ending mid-October), the dollar depreciated by 7 percent against the Japanese yen and 14 percent against the German mark. On a trade weighted basis, however, the dollar's decline was only about 2-1/2 percent, reflecting an appreciation of more than 10 percent against Canada, our largest trading partner.

The main factors behind the exchange rate movements were changes in interest rates in the United States and abroad which reflected differences in economic conditions, particularly growth, and resulted in large interest differentials unfavorable to dollar assets. Towards the end of the period, serious strains developed among European currencies, which triggered large short-term capital flows. On balance, however, these flows did not appear to have a significant lasting effect on the dollar's exchange value.

The dollar reached record lows of DM 1.3865 and ¥ 118.60 in September 1992 but was recovering toward the end of the reporting period as the U.S. economy showing increased signs of recovery while growth in Europe and Japan slowed.

Dollar

The dollar trended downward against most other major currencies through much of the year, apart from a brief period in early 1992 when the U.S. economic recovery briefly seemed to pick up speed. As noted above, the decline primarily reflected a further widening of large differentials between European and U.S. interest rates. Subsequently, declining consumer and business confidence and weakening employment in the United States discouraged any expectation that the differentials would narrow significantly over the near term. Also, the U.S. monetary authorities were perceived as unconcerned about dollar depreciation so long as it was orderly.

Yen

The yen appreciated modestly against the dollar but declined against European currencies. This mixed picture reflected several factors, including a decline in Japanese interest rates as the authorities responded to growing signs of an economic slowdown and increased strains in domestic financial markets. As a result, interest differentials on dollar/yen narrowed somewhat but widened on yen/DM. Moreover, Japanese capital flows reversed from recent years as financial institutions reduced their foreign exposure at a time of increased strain in domestic financial markets. The sharp
rise in Japan's external surplus may also have provided underlying support for the yen. Finally, the announcement of a fiscal stimulus package and measures to prop up financial markets eased pressure on the yen and contributed to some appreciation toward the close of the reporting period.

**European Currencies**

European currencies appreciated steadily against the dollar for most of the year. U.S. monetary easing to stimulate the economy produced the lowest interest rates in more than 25 years. In contrast, German interest rates rose to historically high levels as the rising cost of German unification was financed primarily through borrowing and monetary policy was tightened to deal with the inflationary effects of increased public and private expenditures. As a result, short-term dollar/DM interest rate differentials widened to an unprecedented 6 3/4 percent. A similar increase in interest differentials occurred with other European currencies as they followed German monetary policies through most of the period, despite weaker economic situations, in order to maintain exchange rates under the EMS.

Initially, the exchange rate pressures within Europe were contained as market participants believed that economic policies and performance would converge under the requirements of the Maastricht Treaty for economic and monetary unification. However, the Danish vote rejecting Maastricht weakened this market view and focused attention on the ability of governments to maintain EMS exchange rates in the face of disparate economic conditions. As uncertainties regarding the future of European unification increased in the period leading up to the French referendum on the treaty, speculative pressures intensified.

The authorities sought to combat these pressures through a combination of large scale intervention, increases in interest rates by countries whose currencies were under downward pressure, and statements reaffirming the commitment to Maastricht, including maintenance of the exchange rate arrangements. On September 14, however, the Italian lira's bilateral central rate was devalued by 7 percent. At the same time, Germany reduced the Lombard rate by 1/4 percent. Nevertheless, the markets considered these actions insufficient; massive speculative capital flows out of the lira and into German marks continued and heavy selling pressures also developed against the sterling. Despite very heavy intervention and sharp interest rate rises, the U.K. authorities were forced to suspend sterling from the EMS, and it subsequently depreciated by more than 15 percent. The Italian lira was also suspended from the EMS, and it depreciated by about 15 percent, while the Spanish peseta's bilateral central rate was devalued by 5 percent but remained in the EMS. In addition, Spain, Ireland, and Portugal introduced temporary measures to restrict capital flows.
Following the French referendum on September 20 approving the Maastricht Treaty by a narrow margin, pressures in the EMS shifted largely to the French franc. However, the French authorities were successful in defusing the situation through increases in domestic interest rates and large scale joint French-German intervention. The relatively strong performance of the French economy in recent years also contributed to the credibility of the authorities' efforts to convince the markets that the current exchange rate was sustainable. French market interest rates eased, and the French were able to recover DM reserves spent defending the franc, in subsequent weeks.

Subsequent to the September events, interest rates in Europe declined somewhat as German and other European authorities responded to growing evidence of the economic slowdown and as exchange market pressures eased. The dollar has recovered some of its earlier declines and, by the end of the reporting period, had moved into a DM 1.45-1.50 range.
PART IV: U.S. BALANCE OF PAYMENTS

Medium-Term Overview

The U.S. trade and current accounts have experienced very wide swings since the early 1980s. From a modest deficit on trade ($25 billion) and near balance on the current account in 1980, both balances had moved into deep deficits (in the $160 billion range) by 1987. Subsequently, both deficits turned course and have been on a declining path, at least until quite recently.

The major factors in both episodes were relative growth in the U.S. and major markets, and the exchange rate. During the 1980-87 period of increasing external deficits, U.S. growth outpaced that of our major trading partners and the dollar appreciated substantially. U.S. exports stagnated, while import growth was robust. Since 1988, U.S. growth has slowed substantially while Europe and Japan -- until recently -- experienced strong, investment-led growth as did the Asian newly industrialized economies. At the same time, the dollar depreciated, returning to roughly its 1980 level on a trade-weighted basis. Export growth rebounded dramatically, while import growth moderated.

Recent developments, and the outlook for the trade and current accounts, will continue to depend heavily on these factors. In particular, the recent weakness in demand growth in Europe and Japan has begun to be reflected in weaker U.S. export performance. (In addition to the exchange rate, price competitiveness of U.S. exports will depend on the relative inflation performance of the United States and the ability of U.S. firms to continue to enhance competitiveness in terms of both price and quality.)

Developments in 1992

Trade balance: The U.S. trade deficit in the first half of 1992 (balance of payments basis, seasonally adjusted) was $83.3 billion at an annual rate, up from $77.4 billion in the second half of last year and $73.4 billion for the year as a whole. This modest deterioration, which apparently began during the course of 1991, represents a reversal of the downward trend which began in 1987 and lasted for roughly four years.

First half 1992 exports (unless otherwise indicated, all data are seasonally adjusted on a balance of payments basis) reached $431 billion at an annual rate, up about $15 billion or 3.6% from the full year 1991. However, the year-over-year increase reflects growth early in 1991 -- exports have been "stuck" at just under $108 billion for three quarters, and this apparent flattening-out is confirmed by the most recent monthly data. Strong export growth, which averaged roughly 13-1/2% per year in value terms
between 1987 and 1991, was the major factor in the decline in the trade deficit during that period.

While exports have stagnated so far in 1992, imports -- which actually declined in 1991, due to lower oil prices in the wake of the Gulf War -- have showed signs of renewed growth despite the very modest pace of recovery in the domestic U.S. economy. Imports (both total and non-oil) rose during the first half to $514.3 billion at an annual rate, up $25 billion or 5.1% compared with full-year 1991. Most of the increase came in the second quarter, and was sustained in the third quarter.

On an area basis, the 1992 trade balance has deteriorated (larger deficit or smaller surplus) vis-a-vis most of the industrial countries, but improved (smaller deficit/larger surplus) vis-a-vis Latin America, OPEC, and the Asian NIEs. Export growth has been particularly weak with respect to the other industrial countries, especially Europe, reflecting the very weak demand growth in their economies. This coincidence of weak export growth and trade balance deterioration mirrors the pattern in the overall balance.

**Current account balance:** The current account for the first half of 1992 was in deficit at an annual rate of $48 billion, roughly the same as 1991's $46 billion if the one-time receipts of Desert Storm support are disregarded. The current account typically reflects swings in the trade balance, since trade is still the largest single component -- though the importance of services has increased substantially in recent years.

However, there was a sharp increase in the current account deficit in the second quarter -- to $17.8 billion, from $5.9 billion in the first quarter -- only part of which represented a rising trade deficit. In addition, there was a sharp drop -- over $3 billion -- in net investment income receipts. Foreign direct investments in the U.S., which had been registering losses, shifted to small profits in the second quarter. Like the second quarter pick-up in merchandise imports, this development may reflect the gradual U.S. recovery and thus could represent initial signs of a cyclical deterioration in the current account in coming quarters.

**Capital account:** In principle, the capital account balance constitutes the mirror-image of the current account balance, and the net capital flow should equal the opposing current account flow (i.e., a current account deficit would have as its counterpart a net capital inflow). However, measurement problems mean that the two balances can be quite different.

So far in 1992, the recorded net capital inflow is over twice as large as the current account deficit -- that is, there is a "statistical discrepancy" of $28 billion, compared with the $23.7 billion current account deficit. U.S. investors have continued to
acquire substantial amounts of foreign assets in 1992, in the form of both portfolio and direct investments. Capital outflows in these two categories totaled $86 billion at an annual rate during the first half of 1992, compared with $72 billion for 1991.

There was a strong recovery of foreign private investment in the U.S. in the second quarter of this year, particularly purchases of U.S. securities. Foreign direct investment inflows, which showed a mixed pattern in 1991, also picked up somewhat in the second quarter but remain well below the very high annual levels of 1987–90. There were very substantial (over $21 billion per quarter) inflows of official capital in the first half of 1992.

**Prospects for Full-Year 1992 and 1993**

**Trade balance:** The trade deficit for full-year 1992 is expected to reflect the modest trend of deterioration noted above, beginning in mid-1991. Imports should continue to show modest growth, while exports are likely to remain weak. The net result is expected to be an increase in the trade deficit on the order of $20 billion, to the $95 billion range.

This contrasts with the projection in the previous Report of a modest further decline in the deficit. The principal difference is a less buoyant outlook for exports -- despite a continued strong U.S. competitive position -- in light of weaker demand than previously foreseen in Europe and Japan. (The lower dollar, if sustained, would have significant effects on exports only in the latter part of 1993, due to lags in the responses of prices and volumes.) Expected weak demand in foreign markets coincides with a revival, albeit gradual, in U.S. import demand.

**Current account balance:** The 1992 current account deficit will show a substantial increase from the recorded 1991 figure of $4 billion, which included $42 billion in one-time transfers from foreign governments in support of Desert Storm. There should also be some deterioration in the 1992 current account deficit, compared with the 1991 figure of $46 billion excluding Desert Storm -- a more appropriate basis for comparison. The deteriorating trade balance will be only partially offset by the strong positive trend of recent years in services receipts, where the U.S. is a competitive supplier of a range of activities such as tourism, financial services, and advanced education.

Investment income may show a modest decline from 1991, since the favorable effects of the U.S.-foreign interest rate differential (lower U.S. rates mean smaller payments on foreign assets in the U.S., and vice versa) may be offset by the cyclical effects on direct investment income. (The income of foreign investors in the U.S. tends to rise with domestic business profits. Hence a U.S. economic recovery is likely to increase investment
income payments to foreigners, while sluggish activity abroad will act as a drag on earnings of foreign investments of U.S. firms.)

For 1993, the cyclical factors influencing the trade deficit will continue to generate a modest negative trend, with imports responding to a continued U.S. expansion while foreign demand growth remains subdued. As a result, the trade deficit could exceed $100 billion in 1993 unless exports pick up more strongly than now foreseen.

This further increase in the trade deficit will be only partially offset by the growing surplus on services transactions. In addition, the underlying trend in net investment income is negative due to the growing net U.S. indebtedness resulting from sustained current account deficits. While a higher rate of return on U.S. foreign direct investment may continue for a time, foreign investments in the U.S. should close the gap as they mature.

At the same time, the U.S.-foreign interest differential, presently favoring the U.S. (i.e., interest rates earned on foreign assets in the U.S. are low, while those paid on foreign holdings of U.S. investors are high), should narrow. Thus the medium-term outlook is for further declines in net investment income, as rates of return on foreign investments in the U.S. increase relative to those we earn on our investments abroad. The net effect for 1993 is expected to be a further increase in the current account deficit, to the $70 billion range.

Analysis of the U.S. External Deficit

U.S. external competitiveness remains fundamentally sound despite the slowdown in overseas markets and the resulting dip in U.S. export performance. In contrast to the first half of the 1980s, when U.S. exports were declining as the dollar steadily appreciated against other major currencies, the modest deterioration expected in U.S. current account balances over the next year is likely to be attributed almost entirely to a rise in imports. Export performance is expected to flatten out, but a variety of factors point to the sector's overall resilience.

First, the U.S. competitive position as indicated by a variety of measures (e.g., U.S. relative unit labor costs, the relative unit price of exports, and real effective exchange rates) has improved substantially since the mid-1980s. These factors and possibly others, such as changes in relative capital costs, will continue to benefit U.S. exporters. In addition, U.S. performance on services continues to demonstrate considerable long-run strength.

Second, the new G-7 consensus on growth-oriented policies and the implementation of measures in that direction auger well for further progress in reducing external imbalances. Japan's fiscal
stimulus, for example, should help shift the engine for growth in that country from rising exports to increased internal demand.

Third, G-7 measures to increase growth are expected to contribute to greater exchange rate stability. In this context, the dollar's value has been reasonably stable in recent years and broadly consistent with a competitive U.S. position.

To be sure, the dampening of export growth rates achieved in recent years will be felt. Between 1987 and 1991, the increase in net exports of goods and services accounted for 40 percent of U.S. GDP growth and played a critical role in U.S. job creation. For these reasons, the U.S. assigns critical importance to ensuring that G-7 efforts to strengthen the global economic recovery take hold. At the same time, the United States must take actions domestically to remove impediments to growth and to support continued progress in reducing external imbalances.

Issues Regarding Medium-Term U.S. Balance of Payments Performance

The U.S. current account mirrors the continued imbalance between U.S. national savings and investment. This internal imbalance and U.S. economic performance more broadly give rise to a number of issues, including the sustainability of the U.S. external position and measures to improve national savings.

The decline in the U.S. current account deficit in 1991 (abstracting out Desert Storm inflows) was associated with a sharp drop in private investment (equal to 1-3/4 percent of GDP). At the same time, the modest increase in personal savings was more than offset by the increase in federal government dissavings. Over the medium term, the IMF projects U.S. current account deficits widening somewhat to 1-1/2 percent of GDP, but stresses that policies to improve national savings would contribute to a reduction in the current account deficit.

U.S. economic policies and their implications are reviewed annually in Article IV consultations by the International Monetary Fund. During the most recent review, the IMF noted the likelihood of a strengthening U.S. recovery, but emphasized that medium-term prospects depended importantly on improvements in national savings performance -- particularly regarding the U.S. budget deficit. The Fund believes that the deterioration in the U.S. fiscal position along with forecasts of high budget deficits over the medium-term have major implications for the health and durability of the economic recovery, domestic investment, and the U.S. current account.

The IMF's heavy emphasis on restoring U.S. fiscal balances in the short-term has led it to prescribe a number of revenue and spending measures to close the budget gap. On the revenue side these include energy taxes, value added taxes, and the elimination
of the deductibility of mortgage interest. Spending cuts proposed by the IMF include: reduced farm price supports, cutbacks in Medicare and Medicaid, and further reductions in defense expenditures.

The United States shares the objective of reducing the budget deficit but believes the Fund's proposed remedies, which seek a correction in the fiscal balance of five percent of GDP by 1997, would exert strong downward pressure on the U.S. economy at a time of already sluggish growth. Job creation would suffer and output would remain subdued over an extended "adjustment" period.

In contrast, the United States has stressed the overriding importance of strengthening the recovery and establishing sustainable growth with low inflation. There is broad agreement on the need to address the major structural aspects of the current fiscal imbalance, particularly the rapid increase in outlays for various mandatory programs. However, the more measured approach advocated by the United States envisages a balanced set of policies designed to ensure a more robust upturn in growth in the near term while offering credible prospects for a substantial reduction in the budget deficit over the medium-term.

Such an approach is also consistent with ensuring the U.S. external position remains "sustainable" and does not risk an excessive accumulation of external indebtedness. Although "sustainability" encompasses a variety of factors and market perceptions that cannot be quantified in any meaningful way, the U.S. external position does benefit from a number of strengths and positive trends.

U.S. export competitiveness has increased dramatically in recent years, as was discussed previously. The growth in services exports is expected to continue despite the slowdown in some major overseas markets. Due to the sustained improvement in U.S. competitiveness across a broad range of sectors, U.S. authorities expect a more modest deterioration in the U.S. current account deficit than does the IMF over the medium term, particularly as cyclical factors converge among the major economies.

Further contributing to the stability of the U.S. external position are the size and openness of the U.S. economy and the size and liquidity of U.S. capital markets. These attributes will continue to attract foreign investment to the United States in the foreseeable future. The United States is committed to an open and growing multilateral trade and payments system to facilitate the continued expansion of trade and investment flows. Recent successes in confirming the new consensus on growth among the G-7 countries as well as ongoing efforts to strengthen the economic policy coordination process should contribute further to the smooth functioning of the international economic system.
PART V: ASIAN NEWLY INDUSTRIALIZED COUNTRIES AND CHINA

Background

Under Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, 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 adjustment 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 to permit effective balance of payments adjustments and to eliminate the unfair advantage."

It was concluded in the October 1988 exchange rate report that Taiwan and Korea "manipulated" their exchange rates, within the meaning of the legislation. Pursuant to Section 3004, Treasury initiated 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 unfair competitive advantage.

Treasury concluded that Taiwan in fall 1989 and Korea in spring 1990 were no longer directly "manipulating" their currencies within the meaning of the legislation. These findings were reaffirmed in fall 1990, spring 1991, and fall 1991. However, it was noted that Taiwan's external surpluses remained large and that, in both Taiwan and Korea, exchange rate policy would continue to have an important role to play in promoting economic adjustment.

In addition, the reports concluded that, in Korea, liberalization of remaining exchange and capital controls was required to improve the functioning of the exchange markets and assure the full operation of market forces in exchange rate determination. In Taiwan, foreign exchange and capital controls were cited as impediments to the operation of market forces in exchange rate determination.

China's large external surpluses, including its growing bilateral surplus with the United States, depreciation of the renminbi, and administrative controls over foreign exchange allocation and trade have led the Treasury Department to consider the applicability of Section 3004 to China. The three reports from fall 1990 to fall 1991 concluded that China's trade surplus with
the United States was primarily due to causes other than exchange rate manipulation. However, the reports noted that China's foreign exchange controls were of serious concern. The Treasury Department began discussions with the Chinese authorities on liberalizing these controls.

In the spring 1992 report, the Treasury Department again found no basis for concluding that Korea was manipulating its exchange rate within the meaning of the legislation. But the Department did find that pervasive Korean exchange and capital controls significantly constrain market forces in the currency market. The report concluded that liberalization of these controls, the subject of ongoing bilateral Financial Policy Talks, is imperative to achieve truly market-oriented exchange rates and trade and investment flows.

In the case of Taiwan, the spring 1992 report noted the 1991 rise in the overall current account surplus, the slow pace of adjustment of the bilateral trade surplus with the United States, and the country's extremely large foreign exchange reserves. The Treasury Department also noted Central Bank intervention to moderate upward pressure on the New Taiwan dollar and continued restrictions on capital flows. In this context, the Department concluded that Taiwan was manipulating its exchange rate within the meaning of the legislation. Treasury stated its intention to negotiate specific measures to help achieve a more market-determined exchange rate and substantial adjustment in Taiwan's external imbalances.

For China, the spring 1992 report found a large overall current account surplus for 1991, very substantial foreign exchange reserves, and a sharp 1991 increase in the country's bilateral trade surplus with the United States. The Department determined that a principal cause of China's large external surpluses was its network of pervasive administrative controls over external trade which severely inhibit China's imports. But, in addition, Treasury found that China was manipulating its exchange rate to help attain its balance of payments objectives. The basis for this judgment was the continued devaluation of the administered exchange rate, despite growing external surpluses, and the significant control exercised by the authorities over foreign exchange swap center rates which had also depreciated since the emergence of the large surpluses. The Treasury Department stated its intention to negotiate with the Chinese authorities on reforms to bring about a market-oriented system of exchange rate determination and foreign exchange allocation in order to help permit substantial balance of payments adjustment.

The remainder of this chapter provides an update of balance of payments and exchange rate developments in Korea, Taiwan, and China, and the Treasury Department's current assessment of the applicability of Section 3004 to these economies. (See Table 5.)
The Korean won has depreciated slightly against the U.S. dollar since the spring 1992 report. The nominal depreciation reflects in part the continued adjustment in Korea's external accounts, as well as higher Korean inflation. However, the exchange rate 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 continue to position the authorities to manipulate the exchange rate through indirect means. The Korean government is currently formulating a comprehensive blueprint for financial sector liberalization, expected to be completed by the end of 1992.

Trade and Economic Developments

The Korean economy is stabilizing in 1992 in line with government objectives. Real GNP growth is expected to be held by the government to 6.6 percent this year, compared to 8.4 percent in 1991. Private consumption and exports are leading growth. Inflation, which reached 9.3 percent at end-1991, is improving in 1992 -- consumer prices rose 3.8 percent in the first half of 1992, compared to 6.2 percent during the same period last year. The central bank projects end-1992 inflation to reach 6.5 percent. Unemployment remains low at just over 2 percent of the labor force.

Korea's external accounts have undergone substantial adjustment since 1989. This adjustment -- which moved the current account from a surplus of 2.4 percent of GNP in 1989 to a deficit of 3.1 percent of GNP in 1991 -- has resulted largely from an increase in imports caused by strong growth of the domestic economy; rising wage demands and other factors adversely affecting Korea's export competitiveness; and rising oil import prices and the longer term impact of the Persian Gulf crisis.

A current account deficit of $2.1 billion emerged in 1990, and grew to a record $8.7 billion in 1991. Korean authorities project the current account deficit will fall to roughly $5 billion in 1992. Korea's trade deficit, which reached $7 billion on a balance of payments basis (2.5 percent of GNP) at the end of 1991, is expected to shrink to $2.5 billion in 1992. Notably, first half exports outpaced imports for the first time in four years. Korea's external deficits do not appear to be structural in nature; authorities anticipate external surpluses by mid-decade.

According to U.S. data, the U.S. bilateral trade deficit with Korea in 1991 fell to $1.5 billion, down 63 percent from 1990. In the first eight months of 1992, U.S. data showed a trade deficit with Korea of $1.0 billion, compared to a deficit of $869 million during the same period in 1991.
Reflecting the rise in the external deficits, Korea's gross and net debt figures rose in 1991. After declining steadily since 1985, Korea's gross external debt rose to $39.3 billion at the end of 1991 (14 percent of GNP), from $31.7 billion at the end of 1990. Net external debt reached $12.5 billion at the end of 1991, up from $4.9 billion in 1990. However, the debt service ratio has fallen significantly over the last 5 years, registering roughly 6 percent in 1991, and is expected to decline further to 5 percent in 1992.

Reflecting the recent improvement in Korea's external accounts, Korea's foreign exchange reserves have shown an upward trend in recent months, rising from $13.7 billion at end-1991 to $15.2 billion at end-July 1992, representing 2.5 months of import cover.

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, which were expanded in September 1991 and in July 1992. Exchange rates between the won and third currencies are set in accordance with dollar rates in international currency markets. Foreign banks have accounted for a large share of transactions in the inter-bank markets, generally between 40-60 percent of the total. Reportedly, the Bank of Korea has intervened only occasionally in the market, and other government-owned banks have accounted for only a small share of inter-bank activity.

Since the inception of the MAR system (through October 16, 1992), the won depreciated 12.8 percent in nominal terms against the U.S. dollar. Most of the depreciation occurred over the second half of 1991 and the first half of 1992, with the currency falling only .8 percent against the dollar on a nominal basis since the spring 1992 report. In the last four months the won has appreciated slightly vis-a-vis the dollar due to improvements in the current account, issuance of overseas bonds, and increased capital inflows following the partial opening of the stock market to foreign participation in early 1992.

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.
One of the most onerous controls is the requirement that foreign exchange banks obtain and review, prior to entering into most foreign exchange transactions, original documentation of an underlying commercial transaction. This "real demand" rule seriously hampers the development of Korea's foreign exchange market, reflects the government's continued controlling hand in the foreign exchange market, and its unwillingness to let market forces fully play their role in the economy. Such restrictions are inappropriate for a country at Korea's stage of development.

Other exchange and capital controls severely impede the use of short-term trade finance, such as stringent terms for deferred payments for imports. Direct portfolio investment in Korea was opened to foreigners for the first time in January 1992, but a number of restrictions -- including a 10 percent limit on total foreign investment in most Korean stocks and a 3 percent limit on investment by individual foreigners -- continue to act as disincentives to foreign investment in the market.

The Korean government revised the Foreign Exchange Control Act (FECA) -- renamed the Foreign Exchange Management Act (FEMA) -- in the fall of 1991 to adopt a "negative list" approach to the regulation of foreign exchange transactions. According to the negative list approach, all foreign exchange transactions are to be permitted in principle, with exceptional restrictions explicitly listed in the regulations.

The revised regulations under the new FEMA went into effect September 1, 1992. Treasury's preliminary analysis of the regulations indicates that the list of restricted foreign exchange transactions remains extensive, with little or no relaxation in key areas such as underlying documentation requirements and deferred payments for imports. In some areas, restrictions may have been tightened.

Financial Policy Talks

Capital and exchange controls and other financial policy issues are the subject of the ongoing Financial Policy Talks between the Treasury Department and the Korean Ministry of Finance. The purpose of the talks is to provide a mechanism for addressing specific market access problems that U.S. banks and securities firms face in doing business in Korea, and for encouraging broader liberalization of Korea's financial, capital, and exchange markets. The importance of financial issues to the U.S.-Korean economic relationship was reflected by President Bush's and President Roh's agreement in January 1992 to resolve differences in this area.

In recent sessions with senior Ministry of Finance officials, they have presented an inter-agency workplan for developing a three-staged blueprint for comprehensive liberalization of the
financial sector. Treasury welcomed the commitment to formulate such a blueprint as a positive step.

However, concerns remain about the approach of the initial workplan. In particular, the pace of implementation of later stages is determined by macroeconomic preconditions, including a balance or surplus in the current account, lower inflation, and a narrowing of domestic and international interest rate differentials. Treasury has pointed out to the Korean government that financial sector liberalization will be required to reduce interest rates and domestic costs in order to attain the macro preconditions laid out in the plan. Expedited action by the Korean authorities in modifying these policies will be necessary for the Korean economy to remain competitive internationally.

Stages I and II of the blueprint have been completed and implementation of some initial measures has begun. Although the short and medium term measures already announced address to some extent a few of the individual issues facing U.S. and other foreign financial institutions operating in Korea, they do not constitute significant liberalization of the market. The fundamental areas needing attention (and that have impeded market forces in the foreign exchange market), such as lifting pervasive foreign exchange and capital controls, accelerating interest rate liberalization, and developing capital and money markets, are being addressed in the third and final stage of the blueprint, currently scheduled for implementation in 1997 and beyond.

Stage III is now under preparation and is expected to be completed by the end of 1992. The Korean government is consulting with experts from the International Monetary Fund, the International Bank for Reconstruction and Development, and various research institutes as it formulates Stage III. These institutions can provide detailed advice on formulating a tightly integrated blueprint with more timely implementation of the entire range of needed liberalization measures.

Through the Financial Policy Talks, Treasury will continue the dialogue with the Korean Ministry of Finance as the blueprint is finalized. These issues are also addressed in the financial services negotiations underway in the Uruguay Round of world trade talks.

Assessment

There is no basis at this time for the Treasury Department to conclude under Section 3004 that Korea is manipulating its exchange rate for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. This assessment is based on the following factors: the continuance of significant global trade and current account deficits, 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, although the exchange rate determination system in place in Korea is an improvement over the previous regime, it is far from a truly market-determined one. In particular, Treasury remains seriously concerned that pervasive foreign exchange and capital controls significantly constrain supply and demand in the currency market and provide the potential for manipulation. Liberalization of these controls -- especially the "real demand" rule for foreign exchange transactions -- is imperative to strengthen the role of market forces in exchange rate determination and in Korea's trade and investment flows. In this regard, the extensive list of restricted foreign exchange transactions embodied in the regulations implementing the revised FEMA is disappointing.

Therefore, in the period ahead, the Treasury Department will continue to monitor developments in Korea's external accounts and the operation of the MAR exchange rate system. The Department 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

The Treasury Department continues to be seriously concerned about the lack of appreciable adjustment in Taiwan's continued large bilateral trade surplus with the United States. While Taiwan's overall trade and current account imbalances have declined during 1992, its bilateral trade surplus with the United States has increased. Many factors of course contribute to the persistent surplus that Taiwan has run with the United States during the past several years. Similarly, as trade barriers in Taiwan have been modified, it would be expected that market forces would play a significant role in correcting the bilateral trade imbalance, including appropriate movement in the exchange rate. However, the exchange rate has regrettably played only a limited role in the external adjustment process. The exchange rate does not fully reflect forces of supply and demand, as appreciation clearly seems to be impeded by limitations on capital flows and on foreign exchange transactions.

In the Treasury Department's judgement, intermittent central bank intervention in the exchange market to dampen the rate of appreciation and smooth out exchange rate movements have served to further constrain demand for the New Taiwan (NT) dollar. This combination of official practices and restrictions contributes directly to Taiwan's efforts to generate the trade surpluses it views as essential for reserve accumulation and impedes adjustment of the bilateral trade imbalance.

Trade and Economic Developments

After declining in 1990, Taiwan's overall external surpluses rose in 1991. According to its data, Taiwan's overall trade surplus for 1991 increased to $13.3 billion, a 6.4 percent increase over 1990. Taiwan's global current account surplus increased by 11.6 percent in 1991 to $12.0 billion, and remained at 6.7 percent of GNP. Taiwan's bilateral trade balance with the United States declined at a modest pace in 1991. According to U.S. statistics, the U.S. trade deficit with Taiwan in 1991 was, at $9.8 billion, 11.9 percent lower than in 1990.

Taiwan's trade surplus with the United States has increased in 1992, as foreseen in the spring 1992 report. U.S. data indicate that the bilateral trade surplus increased 12.0 percent to $6.7 billion in the first 8 months of 1992, compared to $6.0 billion in the corresponding period in 1991. This has occurred despite slow growth in the U.S. economy, the ongoing relocation of Taiwan's labor-intensive export industries overseas, and rising wages and production costs and continued inflationary pressures in Taiwan.

Taiwan's official foreign exchange reserves, already the world's largest, increased significantly over the last year to reach $89.5 billion at the end of September 1992 (sufficient to
cover 18 months of imports), compared to $83 billion at the time of the spring 1992 report. For purposes of comparison, the industrial countries on average hold non-gold reserves equivalent to 2-3 months of import cover.

Based on data for the first half of 1992, which show a decline of 27 percent, Taiwan's current account surplus is likely to decrease in 1992 due to a reduction in the overall merchandise trade surplus and an increase in the services deficit. The economy should continue to grow rapidly; real GDP is expected to expand by roughly 7 percent in 1992, following 7.3 percent growth in 1991. Inflation averaged 3.5 percent in 1991 and increased to an average of 4.9 percent over the first three quarters of 1992.

Exchange Rate Developments

The NT dollar has depreciated by 0.7 percent since the last report; the exchange rate stood at NT$25.27/US$1 on October 16. The cumulative appreciation of the NT dollar since the end of 1991 is 1.9 percent.

Since the last report, the Central Bank reportedly continued to intervene directly and indirectly in the exchange market. In addition, market pressures for appreciation have been resisted through continuing controls over capital flows, tight ceilings on the foreign exchange liabilities of all banks, and limitations on the scope of the forward foreign exchange market. The dampening role these measures play in the exchange market are in the judgement of the Treasury Department significant and serve as continued evidence of the unwillingness of the Taiwan authorities to rely on a market-determined exchange rate.

Given the strength of Taiwan's economic fundamentals -- strong economic growth, continued large trade and current account surpluses, large and growing foreign exchange reserves, and a stable political environment -- the depreciation of the NT dollar since mid-July cannot be fully explained by the decline in Taiwan's overall trade and current account imbalances during 1992.

In this regard, the monetary authorities have been forced to formulate exchange rate and monetary policies against the background of political pressure from powerful exporters complaining of declining competitiveness. However, the evidence does not seem to support fears that the nominal appreciation of the NT dollar has seriously damaged the competitiveness of Taiwan's economy. Though the NT dollar appreciated more than 16 percent between September 1987 and September 1992, the real exchange rate has depreciated over the same period, indicating that Taiwan has become slightly more competitive in global markets. In 1992, Taiwan's global exports through September have increased by 7.5 percent over the comparable period in 1991. According to U.S. data through August, Taiwan's exports to the U.S. market have increased
by 11 percent, outpacing overall U.S. import growth, which is up 8.3 percent. As economic growth improves in the United States and Europe in coming months, Taiwan's exports should continue to perform well.

Nor has appreciation of the NT dollar led to a loss of jobs in the domestic economy. With an unemployment rate under 2 percent, the labor market remains tight, leading the authorities to permit an increase in the number of foreign workers in Taiwan. Wages, on average, are increasing by more than 10 percent annually. Taiwan's continued competitiveness provides the monetary authorities with sufficient scope to permit needed exchange rate adjustments without spurring a decline in exports.

Exchange Rate System

Taiwan has instituted a number of measures over the past several years to liberalize the exchange rate system and reduce capital controls. Nevertheless, the system still does not allow the full effect of market forces to be reflected in the exchange rate. Although the rate for foreign exchange transactions is freely determined between buyers and sellers, an array of official practices and restrictions remains which serves to resist pressures for appreciation generated by underlying economic fundamentals. The Central Bank continues to resist pressure for appreciation by intervening in exchange markets directly and indirectly, setting ceilings on the foreign exchange liabilities of foreign banks, limiting the operation of the forward foreign exchange market, and regulating capital flows. With economic fundamentals enhancing the stability of Taiwan's markets, the utility of these various controls and restrictions appears questionable.

The Central Bank needs to increase the transparency of its operations if it wishes to disprove the widespread view that it intervenes in the market directly and through proxies (such as local banks), or that it has on occasion attempted to control the timing of large-scale NT dollar purchases by local market participants in order to dampen pressures for appreciation. In this regard, it appears that the monetary authorities continued to limit appreciation of the NT dollar on a number of occasions between the spring 1992 report and mid-July.

As noted earlier, a number of restrictions severely constrain forward foreign exchange trading and the scope of the forward foreign exchange market, and thus serve to limit the role of market forces in exchange rate determination. Most importantly, foreign exchange liabilities ceilings, which vary from bank to bank, still affect forward trading, and constrain the ability of foreign branches to offer foreign currency loans in Taiwan and to use swap funding for local currency lending. In place of the quantitative limits imposed by these ceilings, prudential concerns in this area could be addressed through other means, such as through risk-based...
capital requirements that apply to the financial institution as a whole.

The scope of the forward foreign exchange market is further restricted by a number of rules that prohibit transactions for non-trade-related purposes, limit trading to authorized banks, impose a sizeable deposit guarantee, and limit the maximum forward period to 180 days. These restrictions have a particularly adverse effect on foreign banks and securities firms both in and outside of Taiwan, as they are prevented from hedging capital in the onshore market.

Until October 1992, Taiwan restricted annual non-trade-related capital inflows and outflows to $3 million per firm or individual (capital flows for trade purposes are unlimited). On October 9, the limit was raised to $5 million, a welcome but marginal improvement. Taiwan also limits the amount of cash an individual can carry in and out of Taiwan (NT$40,000 or about $1,600).

Restrictions imposed by the Central Bank have hindered the ability of foreign institutional investors to make investments in Taiwan. (In recognition of the strong long-term prospects of Taiwan's economy, foreign institutional investors wish to make long-term and large-scale investments in NT dollar-denominated financial instruments.)

Assessment

It is Treasury's judgment that Taiwan is manipulating its exchange rate within the meaning of Section 3004. In the context of Taiwan's continued large overall trade and current account surpluses, a large and increasing bilateral trade surplus with the United States, and excessive foreign exchange reserves, continued official action that directly interferes with the role of market forces in exchange rate determination, such as direct and indirect intervention in the foreign exchange market, must be viewed as an effort by the authorities to inhibit effective balance of payments adjustment.

Subsequent to issuance of the spring 1992 report, the Treasury Department has held two sessions of negotiations with the Taiwan authorities to seek an end to practices that inhibit the operation of market forces in exchange rate determination, capital flows, and foreign exchange transactions, as well as substantial appreciation of the NT dollar. During these negotiations, the Taiwan authorities provided indications that they would review their practices and restrictions to assess changes that might be necessary. However, Taiwan has not yet committed to specific measures that would address fully the concerns raised in the spring 1992 report.

Some adjustment in Taiwan's overall trade and current account imbalances appears likely this year. However, Taiwan's bilateral
trade surplus with the United States has increased in 1992, reversing the reductions achieved in 1990 and again in 1991. Taiwan's immense and growing foreign exchange reserves are excessive, especially given the investment needs of the economy. The existence of continued large external surpluses indicates a continued need for substantial adjustment, and for significant appreciation of the NT dollar to bring this adjustment about.

In the present context, the continuation of official actions and controls that impede market adjustment of the exchange rate are factors which are considered in the Treasury Department's assessment of the adjustment process. In addition to official action, the array of limitations on foreign exchange transactions and capital flows is far too restrictive and impedes the full operation of market forces in exchange rate determination. Given the advanced state of economic development on Taiwan, and the oft-stated desire of the authorities to develop Taipei as a regional financial center, such limitations should be completely lifted.

As noted in Treasury's spring 1992 report, to encourage a continued decline in Taiwan's overall surpluses and promptly effect an appropriate adjustment in its bilateral trade surplus with the United States, the authorities should take steps that would allow the exchange rate to reflect fully market forces. Specifically, they should cease direct and indirect intervention in the exchange market for the purposes of dampening pressures for appreciation, eliminate foreign exchange liabilities ceilings for foreign banks, remove other limitations that restrict the scope of the forward foreign exchange market, and reduce controls on capital inflows and outflows, while making a commitment to phase out the controls completely.

Financial Policy Talks

Taiwan's exchange rate policies are just one source of the discriminatory treatment faced by foreign banks and securities firms. The exchange rate negotiations with the authorities initiated as a result of the spring 1992 report supplement ongoing financial policy talks between the Treasury Department and Taiwan's authorities under the auspices of the American Institute in Taiwan and the Coordinating Council on North American Affairs. These talks provide a forum for addressing specific market access problems encountered by U.S. banks and securities firms in Taiwan, and for encouraging Taiwan's authorities to undertake further liberalization of its financial and exchange markets, and of restrictions on capital flows.

Since the spring 1992 report, and following a round of discussions in Taipei earlier in the year, Taiwan moved to allow all banks, including foreign banks, to process credit card transactions and to deal in short-term money market instruments. These measures directly address concerns raised by the Treasury
Department, and will expand the scope of opportunities available to foreign banks in Taiwan. Nevertheless, U.S. financial services firms continue to face significant denials of national treatment in addition to the constraints imposed by Taiwan's controls on foreign exchange transactions and capital flows. From a broader perspective, Taiwan has approved several other measures that will further modernize the financial sector. Foreign exchange licenses are now available to a wider range of domestic banks, legislation to establish a futures market has been approved by the Legislative Yuan, and gold trading has been deregulated.
China's substantial external surpluses remain a source of serious concern. These surpluses result in large part from pervasive administrative controls maintained by the Chinese authorities on imports and on foreign exchange allocation. In addition, balance of payments adjustment in China has been hindered by an exchange rate system which encompasses a government-determined official exchange rate and an exchange rate determined in the nation's foreign exchange swap centers, where both the supply of, and the demand for, foreign exchange are substantially controlled by the government.

Since the spring 1992 report, the Treasury Department has negotiated with the Chinese authorities on China's system for determining foreign exchange rates and foreign exchange allocation. The goal has been to seek a more market-oriented system and exchange rate, and to promote significant adjustment in China's overall external surplus and its bilateral trade surplus with the United States.

Trade and Economic Developments

China's global trade and current account surpluses remain large but have fallen from their record levels in 1990 and 1991. According to Chinese data (which are not consistent with U.S. trade data -- see below), the merchandise trade surplus in the first 9 months of 1992 fell to an estimated $5.4 billion from $6.1 billion in the same period of last year. Imports increased 21 percent in the January-September period, supported by higher economic growth in China, while exports have also remained strong, rising some 17 percent. China's overall trade surplus for 1992 is expected to be around $7 billion, compared to $8.7 billion in 1991.

China's current account surplus will likely remain large in 1992, although, in line with the smaller trade surplus, it is expected to decline from its 1991 level of $13.8 billion. The continuing surpluses have contributed to a build-up of China's official reserves, which totaled about $47 billion, or about 8 months' import cover, in July of this year. China's large current account surpluses have allowed China to meet its debt service obligations. While debt service as a percentage of export earnings has increased slightly in recent years, the ratio still remained a modest 8.7 percent in 1991.

In contrast to the narrowing of the global trade gap, China's bilateral trade surplus with the United States continues to grow at a rapid pace. According to U.S. data, China's bilateral surplus in the first 8 months of 1992 totaled $11.2 billion, an increase of 56 percent over the same period of 1991. A 41 percent surge in U.S. imports from China, despite relatively slow U.S. growth, combined with a slowdown to 15 percent in U.S. export growth to China,
explains the widening of the bilateral trade gap. Toys, sporting goods, clothing, and footwear led the rapid growth in U.S. imports from China. If these rates of growth were to continue throughout 1992, the bilateral gap would approach $17 billion by the end of the year, compared to $12.7 billion in 1991.

The pattern of China's trade with other major trading partners differed substantially. In the first 5 months of 1992, China's trade surplus with the EC grew by 8 percent, after surging 78 percent in 1991. China's surplus with Japan fell 21 percent in January-May 1992, while its surplus with Hong Kong rose 4 percent. Thus, the expansion in the U.S. trade imbalance with China was very large compared to the changes in China's trade balances with other partners. The growth in Chinese exports to the U.S. was much faster than export growth to other destinations, and the growth of China's imports from the U.S. was slower than import growth from other sources.

It is important to note that there are large discrepancies between Chinese and U.S. trade data, including differences in treatment of re-exports through Hong Kong and other countries. (The United States counts Chinese exports through Hong Kong as products of China if they are not substantially transformed in Hong Kong or elsewhere, while China apparently does not include some portion of these products in its export figures.) China itself continues to claim a small trade deficit with the United States through the first half of 1992. However, Chinese statistics reveal trends in bilateral trade flows similar to those of U.S. data: according to Chinese figures, exports to the United States rose 32 percent in the first half, while imports grew 21 percent.

In other economic developments, boosted by a renewed reform drive beginning early in the year, China's real GNP grew at an estimated annual rate of nearly 12 percent in the first half of 1992. Growth is likely to top 10 percent for all of 1992, greatly exceeding the original target of 6 percent in the current Five-Year Plan. Accelerated growth has raised concerns about renewed inflation, although the rise in the retail price index (a weighted average of administered, guided, and market prices) in the first half of 1992 was running at only a 5 percent annual rate.

Exchange Rate System

China's administered exchange rate, set daily by the central exchange authorities, generally applies to trade transactions under the State Plan. There is also a second rate determined in foreign exchange adjustment ("swap") centers, where joint ventures and other enterprises with foreign participation, domestic entities that are allowed to retain rights to their foreign exchange earnings, and certain individuals may buy and sell foreign exchange or foreign exchange quotas at rates established through a regulated auction system. Outside the official dual rate system, there is a
black market for foreign exchange, which is apparently diminishing in significance but is still sizable.

The authorities use a variety of means to control the allocation of foreign exchange under the dual rate system. Foreign exchange earned by a state enterprise must initially be surrendered to the Bank of China in exchange for local currency at the administered rate. After each sale, the government gives the enterprise a foreign exchange quota according to a retention ratio determined by the government. Retention ratios vary greatly among regions, firms, and products. Domestic firms are permitted to trade only retention quotas among themselves rather than foreign exchange itself.

The authorities also restrict access to the nation's swap centers for prospective buyers and sellers of foreign exchange. Foreign exchange may be purchased in the swap centers only for the importation of goods deemed by the state to be "necessary" for China's development. Swap center purchases of foreign exchange for non-trade-related foreign exchange transactions are restricted. And foreign exchange flows among swap centers in different parts of the country are limited.

These controls on the demand for, and supply of, foreign exchange in the swap centers clearly affect the swap rate itself, which therefore cannot be called a market-determined exchange rate. Moreover, the authorities are positioned to influence the swap rate more directly by intervening in the market or shutting down trading if fluctuations in the rate extend beyond set bands.

For a more detailed description of China's dual exchange rate system, see Treasury's fall 1991 exchange rate report.

Exchange Rate Developments

Administered Rate: On October 16, 1992, the official rate of the renminbi stood at 5.55 yuan to the U.S. dollar. This represents a nominal depreciation against the dollar of roughly 5 percent since the adoption of the "managed float" system in April 1991. However, since the start of this year, the Chinese authorities have held the official rate within a relatively narrow range, generally between 5.45 and 5.55 yuan per dollar.

Swap Rates: For the week ending October 17, 1992, the average swap center rate stood at 6.91 yuan per U.S. dollar. This represents a depreciation of some 20 percent since the start of the year. Swap rates began to depreciate briskly in the spring, as demand for foreign exchange -- boosted by the domestic expansion and resulting growth in imports -- greatly outstripped supply. The depreciation slowed somewhat in September as state enterprises began to supply more foreign exchange to the swap centers and as demand for imports eased slightly.
Having narrowed to less than 10 percent by the beginning of 1992, the spread between the official and swap rates has again widened to about 25 percent.

Controls on Foreign Exchange Allocation and External Trade

China's foreign exchange regime must be viewed in conjunction with its direct controls over imports. The two sets of controls are often overlapping and redundant.

For example, an importer wishing to obtain foreign exchange for non-priority imports must obtain not only approval from the exchange authorities but also an import license from the trade ministry and explicit approval from the ministry responsible for enterprises producing domestic substitutes. The various approval processes do not necessarily operate consistently. Possession of an import license does not guarantee that an importer will be allocated foreign exchange, nor does approval of foreign exchange use automatically entitle the importer to a license. In practice, it appears that the strict import licensing system is often the most significant obstacle to the importer's ability to obtain foreign exchange. Thus an effort to remove foreign exchange controls without a complementary effort to address direct trade restrictions is unlikely to result in a significant adjustment in China's trade flows.

Assessment

China's large trade and current account surpluses, particularly its rapidly growing bilateral trade surplus with the United States, remain developments of major concern. Surpluses of this magnitude create serious trade tensions and must be reduced.

A principal cause of China's surpluses is the network of pervasive administrative controls over external trade, which severely inhibit China's imports, including those from the United States. On October 10, 1992, under authority provided by Section 301 of the Trade Act of 1988, the United States and China signed a Memorandum of Understanding (MOU) which commits China to remove a substantial number of China's external trade barriers. The MOU calls for China to: progressively remove the majority of its nontariff trade barriers such as quotas, import licensing requirements, and other restrictions on imports; enhance the transparency of its trade regime by publishing all trade laws, regulations, and policies; reduce tariffs on a range of products exported by U.S. firms; and eliminate standards and testing requirements as barriers to trade. When fully implemented, the MOU will have achieved a major step toward eliminating China's direct trade controls and should contribute to external surplus reduction.
In Treasury's view, the Chinese authorities also employ exchange rate and foreign exchange policies to attain their balance of payments objectives.

Despite continued large external surpluses which first emerged in 1990, the administered rate of the renminbi remains significantly devalued below its level at end-1989 when it stood at 4.72 yuan per dollar. However, the administered rate has changed very little since the time of the spring 1992 exchange rate report. (The rate was 5.48 yuan per dollar in mid-April 1992.) That report recommended that "China should suspend further devaluation of the administered rate until far-reaching reform of China's trade, exchange, and domestic price regimes has been undertaken...." In this regard, Treasury recognizes and welcomes the fact that there has been no further devaluation. Until far-reaching reform of China's trade and domestic price regimes has been implemented, Treasury continues to find that no further devaluation of the administered rate is warranted.

The Chinese authorities also influence the exchange rate in the nation's swap centers by controlling both the demand for, and supply of, foreign exchange. The average swap center rate has not appreciated over the past two years, notwithstanding the large current account surpluses and resulting build-up of foreign exchange reserves. The limited response of exchange rates to market forces impedes China's balance of payments adjustment.

In the spring 1992 report, the Treasury Department recommended that the Chinese authorities take a number of concrete measures to permit the exchange rate in swap centers to reflect market forces more fully. These included: eliminating the foreign exchange quota system and moving to a complete foreign exchange cash retention system; removing restrictions on access to the foreign exchange swap centers and on use of foreign exchange for specific trade and other purposes; eliminating restrictions on foreign exchange flows among swap centers around the country; and publishing all laws and regulations pertaining to foreign exchange, as well as making any proposed changes available to the public in advance for review.

Chinese officials have expressed support for general reform objectives: a phasing-out of the administered exchange rate, unification of the dual exchange rate system, liberalization of access to the swap centers, and making foreign exchange regulations more transparent. However, the Chinese authorities have not yet indicated the specific nature and scope of the measures they are contemplating to achieve these objectives, or the timing of such measures. Therefore, Treasury has insufficient basis to change its previous determination.

It is Treasury's judgment that China is manipulating its exchange rate within the meaning of Sections 3004. Given the size
of China's external payments surpluses and the level of its foreign exchange reserves, continued use of the administered exchange rate and of regulated swap center rates must be viewed as an effort by the authorities to frustrate effective balance of payments adjustment.

Subsequent to the issuance of the spring 1992 report, the Treasury Department has held two sessions of negotiations with the Chinese authorities to seek substantial progress toward a more market-oriented system of exchange rate determination and foreign exchange allocation, which will contribute to a reduction in large Chinese external imbalances.

The Treasury will continue to engage the Chinese authorities in negotiations aimed at implementation of specific actions to achieve these objectives in the near future.
PART VI: CONCLUSIONS

Over the past year, the United States has successfully achieved a global consensus to strengthen the world economy. Significant measures are now being implemented to ensure the economic recovery underway gathers strength. At the same time, the U.S. is initiating a review of developments in international capital markets with a view toward considering ways to improve economic policy coordination.

A number of positive developments have begun to emerge in the major economies. In the United States, which has experienced six successive quarters of expansion, inflation and short-term interest rates are at their lowest levels in 25 years, providing a solid foundation for a pick-up in investment and growth. Interest rates have been reduced in other major countries, and the scope for further reductions appears to exist. Recent cuts in German interest rates represent a significant shift in direction that could lead to lower rates throughout Europe, stimulating economic activity in major U.S. export markets.

Japan's announcement of a large fiscal stimulus is a welcomed step toward reinvigorating growth in that country while providing a basis for a reduction in its external surplus.

These efforts are steps in the right direction, but more must be done to assure the recovery gathers strength. A sound and growing world economy is necessary to create new jobs and economic opportunity in the major economies and to support the historic movement to free markets and democracy taking place around the world. Recent events highlighting the interdependent and rapidly changing nature of the world economy confirm the need to strengthen economic policy coordination.

The G-7 process has achieved some considerable successes. In the latter part of the 1980s, it played a central role in reducing divergences in policy and performances among the major economies. As a result, economic expansion was sustained over an extended period, external imbalances were reduced, price stability was restored, and exchange markets became more stable.

More recently, the G-7 has achieved a new consensus on reducing policy differences that have inhibited growth. Solid measures are being implemented to fulfill the commitment of the Munich Summit to higher growth and job creation.

Changes in the world economy will require further consideration of ways to ensure strong economic policy coordination in response to evolving developments and new challenges. As recent events have made clear, global capital markets have grown increasingly large, complex, and integrated. New instruments and channels for capital flows have greatly expanded the scope and
speed of market movements. A better understanding of these changes and their implications is needed to provide policymakers a sound basis for developing policies compatible with sustained global growth.

At Secretary Brady's initiative, the G-10 will undertake a study of global capital flows and their implications over the next few months. This analysis will assist G-7 Finance Ministers leading up to the Tokyo Summit to consider ways in which cooperation might be intensified and obstacles to growth removed.

In addition to the major industrial countries, major trading countries like Korea, Taiwan, and China have an important role to play in promoting a healthy, open global economy and adjustment in external imbalances. In this report, Treasury has reviewed the foreign exchange and exchange rate policies of these countries and has assessed whether they are manipulating their exchange rates, within the meaning of Section 3004 of the Omnibus Trade and Competitiveness Act of 1988, to prevent effective balance of payments adjustment or gain unfair competitive advantage in international trade.

**Korea's** current account has undergone substantial adjustment since 1989, shifting from a surplus of 2.4 percent of GNP in 1989 to a deficit of 3.1 percent of GNP in 1991. Korea's trade deficit, which reached $7 billion on a balance of payments basis (2.5 percent of GNP) at the end of 1991, is expected to shrink to $2.5 billion in 1992. Notably, first half export growth outpaced import growth for the first time in four years. Korean authorities anticipate external surpluses by mid-decade.

According to U.S. data, the U.S. bilateral trade deficit with Korea in 1991 fell to $1.5 billion, down 63 percent from 1990. In the first eight months of 1992, U.S. data showed a trade deficit with Korea of $1.0 billion, compared to a deficit of $869 million during the same period in 1991.

There is no basis at this time for the Treasury Department to conclude under Section 3004 that Korea is manipulating its exchange rate for purposes of preventing effective balance of payments adjustments or gaining unfair competitive advantage in international trade. This assessment is based on the following factors: the continuance of significant global trade and current deficits, 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, although the exchange rate determination system in place in Korea is an improvement over the previous regime, it is far from a truly market-determined one. In particular, Treasury remains seriously concerned that pervasive foreign exchange and capital controls significantly constrain supply and demand in the currency market and provide the potential for manipulation.
Liberalization of these controls -- especially the "real demand" rule for foreign exchange transactions -- is imperative to strengthen the role of market forces in exchange rate determination and in Korea's trade and investment flows. In this regard, the extensive list of restricted foreign exchange transactions embodied in the regulations implementing the revised FEMA is disappointing.

Therefore, in the period ahead, the Treasury Department will continue to monitor developments in Korea's external accounts and the operation of the MAR exchange rate system. 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.

Some adjustment in Taiwan's overall trade and current account imbalances appears likely this year. Data for the first half of 1992 show a decline of 27 percent in Taiwan's current account surplus. However, Taiwan's bilateral trade surplus with the U.S., $9.8 billion in 1991, has increased in 1992, reversing the reductions achieved in 1990 and again in 1991. Taiwan's immense and growing foreign exchange reserves are excessive, especially given the investment needs of the economy. The existence of continued large external surpluses indicates a continued need for substantial adjustment, and for significant appreciation of the NT dollar to help achieve this adjustment.

It is Treasury's judgment that Taiwan is manipulating its exchange rate within the meaning of Section 3004. In the context of Taiwan's continued large overall trade and current account surpluses, a large and increasing bilateral trade surplus with the United States, and excessive foreign exchange reserves, continued official action that directly interferes with the role of market forces in exchange rate determination, such as direct and indirect intervention in the foreign exchange market, must be viewed as an effort by the authorities to inhibit effective balance of payments adjustment.

Subsequent to the issuance of the spring 1992 report, the Treasury Department has held two sessions of negotiations with the Taiwan authorities to seek an end to practices that inhibit the operation of market forces in exchange rate determination, capital flows, and foreign exchange transactions, and that prevent substantial appreciation of the NT dollar.

During these negotiations, the Taiwan authorities indicated that they would review their practices and restrictions to assess changes that might be necessary. However, Taiwan has not yet committed to specific measures that would address fully the concerns raised in the spring 1992 report.

As noted in Treasury's spring 1992 report, to encourage a continued decline in Taiwan's overall surpluses and promptly effect an appropriate adjustment in its bilateral trade surplus with the
United States, the authorities should take steps that would allow the exchange rate to reflect market forces fully. In addition to intervention in exchange markets, the limitations on foreign exchange transactions and capital flows are far too restrictive and impede the full operation of market forces in exchange rate determination. Specifically, the authorities should cease direct and indirect intervention in the exchange market for the purpose of dampening pressures for appreciation, eliminate foreign exchange liabilities ceilings for foreign banks, remove other limitations that restrict the scope of the forward foreign exchange market, and reduce controls on capital inflows and outflows, while making a commitment to phase out the controls completely. The Treasury Department will continue to engage the Taiwan authorities in negotiations aimed at implementation of these reforms.

China's large trade and current account surpluses, particularly its rapidly growing bilateral trade surplus with the United States, remain developments of major concern. China's surplus with the United States reached $11.2 billion in the first eight months of 1992, an increase of 56 percent over January-August 1991. Surpluses of this magnitude create serious trade tensions and must be reduced. A principal cause of China's surpluses is the network of pervasive administrative controls over external trade, which severely inhibit China's imports, including those from the United States. In Treasury's view, the Chinese authorities also employ exchange rate and foreign exchange policies to attain their balance of payments objectives.

Despite continued large external surpluses which first emerged in 1990, the administered rate of the renminbi, 5.55 yuan per dollar in mid-October, remains significantly devalued below its level at end-1989 when it stood at 4.72 yuan per dollar. However, the administered rate has changed very little since the time of the spring 1992 exchange rate report. That report recommended that "China should suspend further devaluation of the administered rate until far-reaching reform of China's trade, exchange, and domestic price regimes has been undertaken...." In this regard, Treasury recognizes and welcomes the fact that there has been no further devaluation. Until far-reaching reform of China's trade and domestic price regimes has been implemented, Treasury continues to find that no further devaluation of the administered rate is warranted.

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Subsequent to the issuance of the spring 1992 report, the Treasury Department has held two sessions of negotiations with the Chinese authorities to seek substantial progress toward a more market-oriented system of exchange rate determination and foreign exchange allocation, which will contribute to a reduction in large Chinese external imbalances.

The Treasury will continue to engage the Chinese authorities in negotiations aimed at implementation of specific actions to achieve these objectives in the near future.
APPENDIX

TABLES AND CHART

1. Economic Performance of Key Industrial Countries
2. Measurements of Dollar Movements Versus G-7 Countries
3. Summary of U.S. Current Account
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

I. Real GNP/GDP (percent change; annual average)

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>United States</td>
<td>-1.2</td>
<td>1.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Japan</td>
<td>4.4</td>
<td>2.0</td>
<td>3.8</td>
</tr>
<tr>
<td>Germany*</td>
<td>0.9</td>
<td>1.8</td>
<td>2.6</td>
</tr>
<tr>
<td>France</td>
<td>1.2</td>
<td>2.2</td>
<td>2.7</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>-2.2</td>
<td>-0.8</td>
<td>2.1</td>
</tr>
<tr>
<td>Italy</td>
<td>1.4</td>
<td>1.3</td>
<td>1.5</td>
</tr>
<tr>
<td>Canada</td>
<td>-1.7</td>
<td>2.1</td>
<td>4.4</td>
</tr>
<tr>
<td>Total G-7</td>
<td>0.6</td>
<td>1.7</td>
<td>3.0</td>
</tr>
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</table>

II. Consumer Prices (percent change; annual average)

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</thead>
<tbody>
<tr>
<td>United States</td>
<td>4.3</td>
<td>3.1</td>
<td>3.1</td>
</tr>
<tr>
<td>Japan</td>
<td>3.3</td>
<td>2.2</td>
<td>2.4</td>
</tr>
<tr>
<td>Germany*</td>
<td>4.5</td>
<td>4.9</td>
<td>4.2</td>
</tr>
<tr>
<td>France</td>
<td>3.1</td>
<td>2.9</td>
<td>2.8</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>5.9</td>
<td>3.8</td>
<td>3.0</td>
</tr>
<tr>
<td>Italy</td>
<td>6.3</td>
<td>5.6</td>
<td>5.1</td>
</tr>
<tr>
<td>Canada</td>
<td>5.6</td>
<td>1.6</td>
<td>2.0</td>
</tr>
<tr>
<td>Total G-7</td>
<td>4.3</td>
<td>3.3</td>
<td>3.2</td>
</tr>
</tbody>
</table>

III. Current Account ($ billions and percent of GDP)

<table>
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<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>United States</td>
<td>-4†</td>
<td>-35</td>
<td>-55</td>
</tr>
<tr>
<td></td>
<td>(0.1)</td>
<td>(0.6)</td>
<td>(0.9)</td>
</tr>
<tr>
<td>Japan</td>
<td>73</td>
<td>110</td>
<td>101</td>
</tr>
<tr>
<td></td>
<td>(2.2)</td>
<td>(3.0)</td>
<td>(2.6)</td>
</tr>
<tr>
<td>Germany*</td>
<td>-20</td>
<td>-22</td>
<td>-9</td>
</tr>
<tr>
<td></td>
<td>(1.2)</td>
<td>(1.1)</td>
<td>(0.4)</td>
</tr>
<tr>
<td>France</td>
<td>-6</td>
<td>-1</td>
<td>-0</td>
</tr>
<tr>
<td></td>
<td>(0.5)</td>
<td>(0.1)</td>
<td>(0.0)</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>-11</td>
<td>-19</td>
<td>-19</td>
</tr>
<tr>
<td></td>
<td>(1.1)</td>
<td>(1.7)</td>
<td>(1.6)</td>
</tr>
<tr>
<td>Italy</td>
<td>-21</td>
<td>-25</td>
<td>-33</td>
</tr>
<tr>
<td></td>
<td>(1.8)</td>
<td>(1.9)</td>
<td>(2.4)</td>
</tr>
<tr>
<td>Canada</td>
<td>-26</td>
<td>-20</td>
<td>-21</td>
</tr>
<tr>
<td></td>
<td>(4.3)</td>
<td>(3.4)</td>
<td>(3.3)</td>
</tr>
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</table>

SOURCE: IMF World Economic Outlook. Comparable Administration forecasts for 1992 U.S. growth and inflation are 2.0% and 3.0% respectively, and for 1993, 3.0% and 3.2% respectively.

* All of Germany
† Reflects extraordinary Desert Storm receipts of $42 billion.
Table 2

Dollar Exchange Rates
vs. G-7 Currencies
At Key Dates
(units per dollar)

<table>
<thead>
<tr>
<th>Value of the Dollar in Terms of:</th>
<th>Dollar Peak</th>
<th>Plaza Accord</th>
<th>Louvre Accord</th>
<th>Year Since</th>
<th>Previous Report</th>
<th>Dollar Lows</th>
<th>Current Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japanese yen</td>
<td>261.55</td>
<td>241.00</td>
<td>153.60</td>
<td>130.02</td>
<td>133.88</td>
<td>122.20</td>
<td>120.60</td>
</tr>
<tr>
<td>German mark</td>
<td>3.4730</td>
<td>2.8575</td>
<td>1.8272</td>
<td>1.6928</td>
<td>1.6682</td>
<td>1.3865</td>
<td>1.4505</td>
</tr>
<tr>
<td>British pound</td>
<td>0.9505</td>
<td>0.7326</td>
<td>0.6542</td>
<td>0.5813</td>
<td>0.5726</td>
<td>0.4980</td>
<td>0.5882</td>
</tr>
<tr>
<td>French franc</td>
<td>10.6100</td>
<td>8.7150</td>
<td>6.0860</td>
<td>5.7668</td>
<td>5.6400</td>
<td>4.7380</td>
<td>4.9455</td>
</tr>
<tr>
<td>Italian lira</td>
<td>2169.50</td>
<td>1924.00</td>
<td>1299.00</td>
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<td>1254.50</td>
<td>1063.00</td>
<td>1287.50</td>
</tr>
<tr>
<td>Canadian dollar</td>
<td>1.4043</td>
<td>1.3763</td>
<td>1.3282</td>
<td>1.1286</td>
<td>1.1818</td>
<td>1.1952</td>
<td>1.2488</td>
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Measurements of Dollar Movements
Vs. G-7 Currencies
Percent Appreciation (+) or Depreciation (-)
(through 10/15/92)

<table>
<thead>
<tr>
<th>Value of the Dollar in Terms of:</th>
<th>Since Dollar Peak</th>
<th>Since Plaza Accord</th>
<th>Since Louvre Accord</th>
<th>Since Year Since</th>
<th>Since Previous Report</th>
<th>Since Dollar Low</th>
<th>Since Dollar</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japanese yen</td>
<td>-53.9%</td>
<td>-50.0%</td>
<td>-21.5%</td>
<td>-7.2%</td>
<td>-9.9%</td>
<td>-1.3%</td>
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<tr>
<td>German mark</td>
<td>-58.2%</td>
<td>-49.2%</td>
<td>-20.6%</td>
<td>-14.3%</td>
<td>-13.0%</td>
<td>4.6%</td>
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<tr>
<td>British pound</td>
<td>-38.8%</td>
<td>-19.7%</td>
<td>-10.1%</td>
<td>1.2%</td>
<td>2.7%</td>
<td>18.1%</td>
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<tr>
<td>French franc</td>
<td>-53.4%</td>
<td>-43.3%</td>
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<tr>
<td>Italian lira</td>
<td>-40.7%</td>
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<tr>
<td>Canadian dollar</td>
<td>-11.1%</td>
<td>-9.3%</td>
<td>-6.0%</td>
<td>10.7%</td>
<td>5.7%</td>
<td>4.5%</td>
<td></td>
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Source: New York 9:00 a.m. exchange rates
Table 3

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

<table>
<thead>
<tr>
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<tr>
<td><strong>Total Exports</strong></td>
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<td></td>
<td></td>
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<tr>
<td>Agricultural</td>
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<td>100526</td>
<td>100636</td>
<td>103324</td>
<td>104151</td>
<td>107851</td>
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<td>107580</td>
<td>361698</td>
<td>388705</td>
<td>415963</td>
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<tr>
<td>NonAgricultural</td>
<td>86691</td>
<td>91058</td>
<td>90836</td>
<td>93959</td>
<td>93981</td>
<td>97061</td>
<td>97123</td>
<td>97080</td>
<td>319513</td>
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<tr>
<td><strong>Total Imports</strong></td>
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<td>Petroleum</td>
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<td>118962</td>
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<td>126390</td>
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<td>131998</td>
<td>477365</td>
<td>497557</td>
<td>489398</td>
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<tr>
<td>Non-Petroleum</td>
<td>15461</td>
<td>18217</td>
<td>12924</td>
<td>12937</td>
<td>13122</td>
<td>12195</td>
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<td>12965</td>
<td>50920</td>
<td>62298</td>
<td>51178</td>
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<tr>
<td><strong>TRADE BALANCE</strong></td>
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### Table 4

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

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#### 30-Oct-92

**US Reserve Assets**

(Incr(-)Decr(+) -337 4179 1073 -420 3180 -437 -38 -209 1270 2305 3396

**Foreign Official Assets**

| Industrial | 14097 20127 5650 -4178 4115 12819 21192 21071 8489 33908 18406 |
| OPEC       | -1699 757 660 -2699 -4288 1023 2459 -2205 10738 2163 -5304 |
| Other      | 2565 6712 13672 1830 8245 8592 12661 10023 -2011 6198 32339 |

**Banks, net:**

| Claims     | -9772 22976 17909 -1846 2403 -23219 15859 | 12592 | -51255 7469 -4753 |
| Liabilities| 27420 18552 -18240 -27411 8508 23465 -4474 5133 63382 16370 -13676 |

**Securities, net:**

| Foreign Securities | -1037 -8111 -9526 -11783 -12403 -11305 -8703 -8573 -22070 -28765 -45017 |
| U.S. Treasury Securities | -544 -3044 2850 13289 -1306 1408 -828 10288 29618 -2534 16241 |
| Other U.S. Securities | -2874 1041 4862 15212 10012 4832 4551 10872 38767 1592 34918 |

**U.S. Direct Invest. abroad:**

| Reinvested Earnings | -4719 -5909 -6000 -3993 -3217 -4675 -3657 -4246 -14780 -19469 -17885 |
| Equity & Inter-co. Debt | -12058 2235 -5994 7674 -3911 -7017 -11418 -6760 -14218 -13225 -9248 |

**For. Direct Invest. in U.S.:**

| Reinvested Earnings | -3325 -6619 -5256 -5122 -4270 -5398 -4459 -2570 -8530 -16284 -20046 |
| Equity & Inter-co. Debt | 10796 19712 3724 12344 4299 11078 639 8559 76402 61424 31545 |

**Other U.S.-Corp., net:**

| Claims     | -4780 -5142 2251 2304 -298 1269 4764 n.a. 11398 -2477 5526 |
| Liabilities| 4728 -1661 -1430 -1275 1575 725 1942 n.a. 5565 4906 -405 |

**NET CAPITAL FLOWS:**

| 20422 | 22745 | -12193 | -2431 | 11086 | 7217 | 5903 | 17788 | 101142 | 00433 | 3679 |

**Statistical Disc.**

| 3556 | 11452 | -3713 | 1660 | -1478 | 2447 | -8410 | -19567 | 2397 | 41737 | -1084 |
|----------|------|------|------|------|------|
|          |      |      |      |      |      |
| DM       | 1.8% | 1.2% | 1.3% | 1.9% | 2.2% |
| NTS      | 1.3% | 1.7% | 2.2% | 3.5% | 4.4% |
| SS       | 0.3% | 0.5% | 0.8% | 1.1% | 1.4% |
| HK$      | 0.6% | 1.0% | 1.1% | 0.8% | 0.4% |
| Since:   | 0/9/78 | end-88 | end-86 | end-88 | Report |

Cumulative Change Against US$ as of October 16, 1974 [1]
Real Trade-weighted Exchange Rate Indices for the Dollar, Yen, and DM from 80/1 to 92/10*

Note: A rise in the index = appreciation/decline in competitiveness; a fall in the index = depreciation/increase in competitiveness.