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CURRENCY MANIPULATION

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

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OPENING STATEMENTS

CURRENCY MANIPULATION

FRIDAY, MAY 12, 1989

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON INTERNATIONAL TRADE,
Washington, DC

The subcommittee met, pursuant to notice, at 10:05 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

[Press Release No. H-20, April 19, 1989]

FINANCE SUBCOMMITTEE ON TRADE TO HOLD HEARING ON CURRENCY MANIPULATION

WASHINGTON, DC—Senator Max Baucus (D., Montana), Chairman, announced today the Subcommittee on International Trade will hold a hearing to explore the problem of some newly industrialized countries manipulating the value of their currencies to maintain a trade surplus, and to discuss the U.S. response to this practice.

The hearing is scheduled for *Friday, May 12, 1989 at 10 a.m.* in room SD-215 of the Dirksen Senate Office Building.

"The U.S. Treasury Department has already officially identified Korea and Taiwan as nations that manipulate the value of their currency. Currency manipulation is the next generation of trade barriers," Senator Baucus said.

"By manipulating the value of their currency, nations can gain an unfair trade advantage. At a time when the U.S. is running a mammoth trade deficit, this practice is simply intolerable," he said.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN OF THE SUBCOMMITTEE

Senator BAUCUS. The hearing will come to order.

After World War II, the United States convinced the world's major trading nations to join in establishing the general agreement on tariffs and trades, more commonly known as the GATT. The purpose of the GATT was to promote freer trade by lowering the major trade barrier of the time, tariffs. And the GATT succeeded because after four rounds of GATT negotiations, worldwide tariff levels were slashed by more than 50 percent.

Unfortunately, as the tariff barriers came down, non-tariff barriers to trade rose. The first generation of non-tariff barriers, quotas and import bans, were easy to seek and relatively easy to limit in trade agreements.

But as the GATT was extended to cover the first generation of non-tariff barriers, still another generation of barriers sprung up. The quotas of the late 1950's and 1960's became the subsidies and discriminatory standards of the 1970's and the 1980's.

And so the cycle continues with new and more subtle trade barriers being developed as new international trade agreements are negotiated. In the Omnibus Trade Act of 1988, Congress tried to get ahead of the game by addressing some emerging trade-distorting practices, most notably currency manipulation. Currency manipulation broadly defined is the governmental practice of intervening to keep the government's currency artificially undervalued in order to promote exports and discourage imports.

We addressed the problem of currency manipulation in the Trade Act because currency manipulation can be used to frustrate trade liberalization efforts. If a nation manipulates its currency so that the currency is undervalued by 10 percent, it has approximately the same effect as a 10 percent across-the-board tariff combined with a 10 percent across-the-board export subsidy.

A number of private economists, including some testifying today, have found that several nations, most notably Korea and Taiwan, are manipulating their currency to ensure a trade surplus. In the Trade Act Sections of 3004 and 3005, we require the Treasury Department to identify those nations that were manipulating their currency to maintain a trade surplus. The Treasury Department was then required to start negotiations to end the manipulation.

In a separate provision, Section 1124, the Administration is required to initiate negotiations on an expedited basis if the nations that manipulate their currency are engaged in a trade negotiation with the United States. Although a few deadlines were missed, the Administration has generally done an exemplary job of implementing Sections 3004 and 3005.

The Treasury Department identified Korea and Taiwan as currency manipulators. As Treasury noted, during the period that the Japanese yen appreciated 83 percent against the dollar the Korean won appreciated only 34 percent and the New Taiwan dollar appreciated only 49 percent.

Negotiations to convince Korea and Taiwan to appreciate their currencies are now proceeding. I am concerned, however, that we have not sufficiently integrated our negotiations on trade barriers and our negotiations to end the practice of currency manipulation. According to the national trade estimate, Korea and Taiwan also maintain extensive trade barriers. One or more may soon be designated as priority countries under Super 301.

If they are designated priority countries, the U.S. will begin negotiations aimed at eliminating their trade barriers. If such trade negotiations begin with Korea and Taiwan, I urge the Administration to fully implement Section 1124 and closely coordinate trade negotiations with currency negotiations dealing with currency manipulation. We must ensure that the gains we make at the trade negotiating table are not wiped out by currency manipulation.

Today we will review progress made in implementing the currency manipulation provisions of the Trade Act with Mr. David Mulford, the Under Secretary-Designate of the Treasury Department, the GAO, and two distinguished economists. I look forward to a frank and productive discussion of these issues.

We begin first with the Honorable David Mulford who has been a very busy man this morning, just recently testifying for another committee, the Banking Committee. Mr. Mulford, we are honored to have you here and look forward to your testimony.

Why don't you proceed?

STATEMENT OF HON. DAVID MULFORD, UNDER SECRETARY-DESIGNATE, OFFICE OF INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Secretary MULFORD. Thank you very much, Mr. Chairman. It is a pleasure to be here this morning.

I welcome the opportunity to discuss the issues related to the exchange rate practices of Korea and Taiwan, particularly as the Treasury Department has released recently a report on international economic and exchange rate policy which addresses these particular matters.

For the last several years we have sought to reduce global trade imbalances in the context of a growing world economy. Our efforts to coordinate our economic policies with other major industrial countries have focused on this goal. Indeed, last year economic growth in the G-7 exceeded expectations and there was a significant reduction in global current account imbalances. This strong performance provides a solid basis for continued progress in 1989, although there is some concern that external adjustment is slowing and that further efforts will be required.

We also recognize that others should play an integral role in preserving and ensuring a strong, stable world economy. In particular the newly industrialized economies of Asia have benefited from an open, growing international trading system. As such, it is essential for them to work toward reducing global imbalances by allowing the value of their currencies to reflect the strength of their economies and by dismantling trade barriers to trade and investment.

To that end, we have held discussions with the Asian NIEs beginning in middle 1986. The 1988 Trade Act provided impetus to this process by requiring the Secretary of the Treasury to issue periodic reports on international exchange rate policy and to determine which economies manipulated their exchange rates.

In our first report, issued in October last year, we concluded that Korea and Taiwan were manipulating their exchange rates to gain a competitive advantage within the meaning of the legislation. Consequently, as required by the legislation, we have intensified our negotiations with Korea and Taiwan.

In reaching the conclusion concerning manipulation of exchange rates, we looked a wide range of factors to determine whether Korea and Taiwan were in fact manipulating their exchange rates. An important factor was the existence in both cases of pervasive capital controls and administration mechanisms aimed at preventing the exchange rate from reflecting market forces.

A second factor was large-scale intervention in the local foreign exchange market by the Central Bank. A third factor was the lack of significant exchange rate appreciation at a time when Korea and Taiwan were running very large external surpluses in both absolute terms and relative to GNP. This relative lack of appreciation was particularly striking when compared with the appreciation of the currencies of other surplus economies.

Our negotiations with Korea and Taiwan have been aimed specifically at ending such currency manipulation. We have also sought other policy changes, including structural reforms to give greater emphasis to domestic demand as a source of growth and the liberalization of financial markets.

These negotiations have led to some encouraging progress. The currencies of both Korea and Taiwan have appreciated further. In addition, they have take measures to open their markets and to varying degrees internationalize their financial systems. Indeed, we believe that due to these factors a structural decline in their external surpluses may well have begun. At the same time we believe that more progress is necessary.

Appreciation of the Korean won accelerated in 1988, reaching nearly 16 percent, including about 4 percent in the 6 weeks following the release of the October report. Also, unlike in previous years, the won began to strengthen against the currencies of key competitors, such as Japan and Taiwan.

Although we welcomed the appreciation of the won in 1988, its adequacy must be judged against its much slower appreciation in 1987 and the size of Korea's external surpluses. In 1988, Korea's global current account surplus grew 44 percent to $14.3 billion. To put this in perspective, one need only realize that it was equal to 9.1 percent of Korea's GNP. In comparison, Japan's 1988 current account surplus was equal to 2.7 percent of GNP.

The United States' bilateral trade deficit with Korea began in 1988 to show some limited prospects of improving, growing by only 1 percent compared with a 34 percent increase in 1987. Encouragingly, this reflected stronger growth of our exports to Korea and decline in the rate of growth of our imports. Nonetheless, at $9.5 billion our bilateral trade deficit remains unsustainably large.

Preliminary Korean data for the first quarter of this year suggests a potentially significant decline in the trade and current account surpluses due in part to the prior appreciation of the won. This data also indicate that Korea's bilateral surplus with the United States fell by 34 percent to $1.2 billion.

Unfortunately, the response of the Korean authorities to these welcome developments has been to reduce sharply the pace of the won's appreciation this year. Since the beginning of the year, the won has strengthened by only 2.7 percent against the dollar. Much of this occurred since late March following another round of negotiations and the beginning of the preparation of our April report to Congress.

While we are somewhat encouraged by Korea's trade developments, we believe that the Korean current account data are too limited and too preliminary to demonstrate clearly that a structural lasting decline in Korea's external surplus is underway. Indeed, we expect Korean exports to begin to recover in the second quarter once the current labor disputes have been resolved. As such, further exchange rate appreciation is necessary to sustain and reinforce recent developments.

However, due to the concerns about the first quarter decline in the surplus, the Korean authorities have not been willing to provide assurances to us of adequate continued won appreciation. Our negotiations with Korea in the coming months will be aimed at obtaining assurances of continued appropriate appreciation. In particular, we will seek to engage the Korean authorities in a broad dialogue on their capital markets, including exchange controls, and the banking and securities markets. We will also seek to obtain an understanding on the implementation of a market-based exchange rate system and the dismantling of the current system of comprehensive capital and exchange controls used to manipulate the exchange rate.

A decline in Taiwan's external surplus is also occurring. Taiwan's global current account surplus decreased by 43 percent in 1988 to $10.2 billion or 8.5 percent of GNP. According to U.S. Customs data, the trade imbalance with Taiwan, which accounts for 95 percent of its global trade surplus, fell last year by 26 percent to a level of $12.7 billion.

However, the large U.S. exports of gold to Taiwan accounted for more than half of this reduction. Preliminary Taiwanese data for the first 4 months of 1989 point to further reductions in Taiwan's trade surplus with the United States compared to the same period in 1988 if last year's gold shipments are excluded.

The past appreciation of the New Taiwan dollar has been an important factor in the reduction of Taiwan's external surpluses. Furthermore, since the October report the exchange rate has appreciated by 12 percent. Significantly, 5 percent of this movement has been since the release of our April report. We believe that this exchange rate appreciation will reinforce the positive trends in Taiwan's external surplus.

Taiwan also implemented a new exchange rate system in early April following a round of negotiations. Without this change, the recent currency appreciation probably would not have occurred. This new and more market sensitive system could represent an important step towards the establishment of a market-based system to determine the exchange rate. However, it is premature at this point to make a definitive assessment of its impact.

The effectiveness of the liberalization will depend on reducing the extent of central bank intervention, removing the remaining controls on capital inflows, and resolving a number of operational problems within the system. Consequently, we will continue in the coming months to monitor carefully its implementation and operation.

Given the recent sharp appreciation of the New Taiwan dollar, the reduction in external surpluses and the institution of the new exchange rate system, there may not be a need for further appreciation of the New Taiwan dollar at this time. We will, however, continue to monitor Taiwan's exchange rate in trade developments closely to ensure that momentum towards external adjustment is sustained.

In conclusion, Mr. Chairman, we believe that Korea and Taiwan have an important role to play in reducing external imbalances. The progress we have achieved in our bilateral negotiations with Korea and Taiwan could lead to a sustainable decline in their external imbalances. In the period before our next report in October, we will aim to have these economies continue to correct their policies to avoid an unfair competitive advantage in trade and hence contribute to the global adjustment process.

Thank you very much, Mr. Chairman.

[The prepared statement of Under-Secretary Designate Mulford appears in the appendix.]

Senator BAUCUS. Thank you, Mr. Secretary.

First, I would like you to tell us just generally—and I know it is hard to quantify this—but generally, how much further do you think the New Taiwan dollar and the won should appreciate to indicate to us that basically it is market determined?

Secretary MULFORD. Well, Mr. Chairman, the answer to that question I think is very hard to be precise about, and politically, I think rather unwise to be precise about in public. I would be happy to meet with you privately on the magnitudes of change that are sought, but let me say that, first of all, those magnitudes are affected at any given time by what the recent movements have been and what the recent trade figures look like in the way of development. And for example, in the case of Taiwan, they have now moved sufficiently for the time being for us to take the view that this may well have a continuing positive effect on their adjustment. So one has to withhold judgment, not set a particular target, because that target could be overtaken quickly by events. It may be necessary to suggest that they should be moving further. So it is very hard to get stuck with a particular number.

On the second part of your question, making a determination as to whether or not they have an appropriate exchange rate system, that I think is easier. Taiwan, by making the change it made in early April, has instituted a more market-sensitive system, which I can describe if you wish, where market forces, although not in control, do have an influence on movement that will make it more difficult for the authorities to control the exchange market.

That is a very positive step, and I think in the end our judgment on whether their exchange rates are appropriate or not must be based in part on whether they have a system that allows the market to function, so that exchange rates can reflect the underlying economic fundamentals. In Korea they do not have an exchange market system that is at all market sensitive.

Senator BAUCUS. Now, you are saying that to some degree or generally at this point that perhaps the New Taiwan dollar has appreciated sufficiently, whereas the Korean won has not.

Could you further amplify the reasons why you tend to think that one country perhaps has appreciated enough, i.e., Taiwan, but Korea has not? What is the essential difference?

Secretary MULFORD. Well, the essential difference is that, for example, if you go back to the time of the Plaza Agreement, for example, as a bench mark, and you look at the Korean won, it has moved approximately 34 percent up through May 11th. The New Taiwan dollar has moved about 58 percent. Now that compares during the same period with a move of the yen of 78 percent and a move of the Deutschmark of 50.6 percent appreciation against the dollar.

So, if you move then to October 14 last year, which was when we put the report in, and you take a look at what has happened since then, in the case of the won you see a 6½ percent move, so that a relatively modest proportion of the 34 percent has happened since last October. And this year the movement, as I said in my testimony, has been very small, 2.7 percent, and almost all of that came in a very short period just before we put the report in.

In the case of Taiwan, the movement since last October has been close to 13 percent and they moved a full 5.7 percent after we had done the report, we think partly as a result of the more market-sensitive exchange system that drove those rates a bit, or I should say let the rates move more freely. So that is what I would sort of assess on the exchange rate side.

On the surplus side, as I indicated, there has been some shift in both countries' surpluses and this would suggest that adjustment is taking place. If Taiwan continues to have a market-sensitive exchange system operating, the chances are that the adjustment process will continue because the exchange rates will reflect what is happening.

In the case of Korea, it is obviously a managed, a closely managed, exchange market. Market forces are almost irrelevant, and therefore, the exchange market arrangements are not a guide to what may happen and it is clear that for the Koreans to continue the adjustment, they will have to engage in further appreciation.

Senator BAUCUS. So you are saying that with respect to Taiwan that even though the New Taiwan dollar has appreciated only 58 percent compared with 78 appreciation of the yen, that because of the decline in the surpluses and because you think that trend will continue with the relatively recent appreciation of the New Taiwan dollar that, therefore, we should not proceed too much further to try to force more appreciation of the New Taiwan dollar. Again, it goes back to the drop in the surplus and your forecasted continued drop in the surplus; is that correct?

Secretary MULFORD. Well, yes, in a way. What makes it difficult is there is quite a long period of time required for the trade patterns to be affected by the exchange rates moves, so the trade figures that are coming through at the moment reflect exchange rate changes 9 months or a year before. These rather important changes made by Taiwan will feed through, we think, in the form of better figures 6, 9, 12 months from now and will continue the adjustment process, and we have simply taken the view that for the moment it would appear that the New Taiwan dollar's appreciation is sufficient. But for the moment, it may be necessary since surpluses remain very large in both these countries. It is going to be important that the adjustment process continue and that will probably mean further appreciation in the future.

Senator BAUCUS. That is the point I was going to get at. When you say "for the moment," because the surpluses are so large still——

Secretary MULFORD. Yes.

Senator BAUCUS [continuing]. It probably will mean more appreciation even of the New Taiwan dollar be necessary.

Secretary MULFORD. In due course, I would not be surprised.

Senator BAUCUS. Yes.

Now some, in defending the lack of appreciation of the Korean won, will point out that Korean wage rates have increased significantly and increases in wage rates are a cost of doing business to Korean businessmen. Therefore, they say, it is not appropriate for the United States to push for a continued appreciation of the Korean won.

What is your response to that point?

Secretary MULFORD. My response to that is that wage rates are one economic factor that have a bearing on the competitiveness of Korea certainly, but there are Lundamental economic policy changes that should be made in Korea to open and liberalize its economy to allow the full—and the exchange rate is one of those policies—to allow the exchange rate to fully reflect the underlying strength of the economy, and therefore, wage rates, while a factor, are not the whole story and are not really a factor that would substitute for exchange rate adjustment.

Senator BAUCUS. Well, isn't it true that in all probability with wage rate increases there is productivity increase too which would tend to counterbalance these——

Secretary MULFORD. That could be true, sure.

Senator BAUCUS. And second, the increase in wage rates does not affect U.S. exports to, say, Korea. Increased wage rates have a greater effect on exports of Korean products.

Secretary MULFORD. That is right.

Senator BAUCUS. And less of an effect on exports of American products to Korea.

Secretary MULFORD. Yes, that is right.

Senator BAUCUS. Do you agree that because gains in reducing trade barriers might be offset by currency manipulation, it is important to integrate trade negotiations with currency manipulation negotiations?

Secretary MULFORD. I think that there should be clearly a relationship between macro-economic policy and trade policy, trade policy being often rather product or sector specific. With reference to exchange rates, I think that one needs to remember that exchange rates have a very, very broad impact and do not necessarily lend themselves to the kind of negotiating process that goes on with regard to a specific trade policy or trade product issue. So, although there needs to be close coordination—the issues are related—I would not recommend that they would be put together, for example, under a particular trade action, for example.

Senator BAUCUS. Like, say, a Super 301?

Secretary MULFORD. Yes, I would not recommend that. I think that that approach would have a lot of disadvantages.

Senator BAUCUS. Could you explain that a little more fully, please?

Secretary MULFORD. Yes, I think that, for example, a 301 action has a prescribed methodology and procedure about it, including a set period of time during which certain negotiations take place, followed by the need to make a decision on retaliation if these have not proceeded according to plan.

I think in an exchange rate negotiation, one has to be much more sensitive to the fluidity of the situation. We have been able to accomplish important changes in both Korea and Taiwan at differing periods of time and under differing circumstances. I think we would lose that flexibility and fluidity if we were locked into a formal procedure, such as a 301.

In addition, it may well be, as we have seen in the case of Taiwan, that at some point during that process, you have achieved enough for the time being to accomplish your near-term objectives, and it would be, I think, inappropriate, if that was the case, to then be forced to go on with a formal negotiation and possible decisions on retaliation that make the form too inflexible as to on going economic developments. So I really feel that it would be a loss of substantial subtlety and fluidity in the negotiation if you were forced into that kind of a format.

Senator BAUCUS. Well, I think that you are right. It certainly hurts. The negotiations need more fluidity and, as you put it, subtlety, but I also think it is important that there be close coordination. There should not be the same time constraints. That is, I do not think it makes sense to have the same time constraints in currency manipulation negotiations as one might have, say, on trade negotiations, but I do strongly believe that it is important for each to have the eye on the other so that we have a common American policy with respect to a particular country. In all probability, the currency negotiations should be, as you say, more fluid because it deals more on a macro level than would a trade matter.

Secretary MULFORD. I think that is right. You need to have that coordination, but let me cite an example of what happens when the two get merged too close together in terms of an agenda. This is a constant problem with both Korea and Taiwan.

Over the past 3 years, because they have found it extremely difficult politically to address their currency problem because that does involve fundamental structural change in their economies that is more or less permanent and sometimes politically rather painful—that adjustment process—there is a tendency, if you bring issues such as specific trade items together with currency, for the governments to say, "Okay, we will make 1,500 changes in our trade policy and we will reduce tariffs by X and we will send a buying mission to the United States to buy a large volume of products, but we are not changing our currency." And it makes it difficult then to say, "Well, thanks, but no thanks."

But the facts are that unless the currency situation is addressed successfully, the fundamental and permanent structural changes to those economies will not take place, and the trade actions that are taken often will prove to have only very temporary results, so the currency situation remains unresolved and they have bought time. So that is an example of the kind of thing we have been up against from time to time. You have to have sort of a continuing dialogue running over a long period of time on the currency issue.

Senator BAUCUS. Are you, therefore, saying that it works both ways, that if a country makes progress on currency manipulation but not on trade negotiations, the progress on currency should not be a factor on whether or not be the United States, say, names a country under Super 301?

Secretary MULFORD. I do not think that the currency issue should be brought under the 301 umbrella. Obviously, it is an issue in making the decision about countries.

Senator BAUCUS. When we wrote that provision, I think it is fairly clear that it was our intent that it be treated separately; that is, that it not be a part of our intent.

I have no more questions. I want to thank you very much, Mr. Mulford, for testifying.

Secretary MULFORD. Thank you very much, indeed, Mr. Chairman.

Senator BAUCUS. We are going to have to temporarily recess—and when I say "temporary," I mean 5, 6 minutes—and the committee will then reconvene in about 5 or 6 minutes.

[Whereupon, at 10:36 a.m. the hearing was recessed.]

[AFTER RECESS]

Senator BAUCUS. The hearing will come back to order.

I, first, apologize to the witnesses for that delay of more than 5 or 6 minutes.

Our panel consists of several very distinguished in international finance and currencies. First, Mr. Allan Mendelowitz, who is Director of Trade, Energy and Finance Issues with the National Security and International Affairs Division with the GAO. He is accompanied by Mr. David McClure, also GAO.

The second witness will be John Williamson, who is a senior fellow for the Institute for International Economics; and third, Mr. Fred Bergsten, who is the Director for the Institute for International Economics.

So first, let us hear from GAO.

Mr. Mendelowitz.

STATEMENT OF ALLAN I. MENDELOWITZ, DIRECTOR, TRADE, ENERGY AND FINANCE ISSUES, NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION, GENERAL ACCOUNTING OFFICE

Dr. MENDELOWITZ. Thank you, Mr. Chairman.

With your permission, I will try to cut out things that were repetitious of data provided by Mr. Mulford earlier today.

In addition to Mr. McClure, who was the project manager on the assignment we undertook on exchange rates, we are accompanied today by Dr. Jane Li, who was the senior economist on the project and I would like to recognize her and have her name entered into the record.

Senator BAUCUS. Dr. Li, glad to have you here.

Dr. MENDELOWITZ. I am pleased to be here today to discuss with you our review of how currency exchange rates are determined in Taiwan, South Korea, and Hong Kong.

Our study was undertaken at the request of the Chairman of the Senate Committee on Finance, Lloyd Bentsen, and the report was issued at the end of April.

Despite an 18 percent drop in the U.S. trade deficit with these three Asian NICs from $35.4 billion in 1987 to $29.2 billion in 1988, it continued to represent over one-fifth of the total U.S. trade deficit. The improvement in 1988 was attributable to a trade deficit reduction with Taiwan of $4.8 billion, and as was noted, about $2.5 billion of that was gold bullion exports from the United States to Taiwan, and a reduction of the trade deficit with Hong Kong of $1.4 billion.

Senator BAUCUS. Before you proceed further, I would like to inform each of you that I have limited each to 5 minutes. Although Secretary Mulford was 10 minutes, so you are 5, so you can adjust your testimony accordingly.

Thank you.

Dr. MENDELOWITZ. No problem.

The sharp increase in the U.S. trade deficit with these Asian NICs resulted from a rapid increase in the U.S. imports from them while U.S. exports increased much more slowly. Several factors have contributed to the U.S./Asian NIC trade imbalance in the 1980s. Among these were the low-valued Asian NIC currencies relative to the U.S. dollar and the Japanese yen, systemic differences between the Asian NIC and U.S. economies, and historical trading patterns among the Asian NICs, Japan, and the United States.

With respect to how the exchange rates in these countries are determined, the Hong Kong dollar is freely convertible with the U.S. dollar at a fixed rate, and Hong Kong lets its economy adjust to changes in its trade balance through fluctuations in its money supply, and consequently price level, rather than through changing the value of its currency. Even though there are market mechanisms that keep the fixed exchange rate system working, Hong Kong has intervened periodically in the foreign exchange market. During 1987 and 1988, it bought U.S. dollars to counter an inflow of speculative funds attracted by the anticipation of appreciation of the currency.

Taiwan made major changes to its foreign exchange operations on April 3, 1989. Prior to these changes, Taiwan's central bank used two government controlled banks to intervene in foreign exchange markets on a near-daily basis. The intervention was used to influence the daily closing rate of the New Taiwan dollar, which in effect determined the next day's opening rate. In the first month following Taiwan's changes to its foreign exchange rate operations, the New Taiwan dollar appreciated against the U.S. dollar in nominal terms by 8 percent. A dramatic 1-day change between May 2 and May 3 accounted for almost 7 percent of this change.

The exchange rate for the South Korean won is not allowed to fluctuate freely on foreign exchange markets. Korea's central bank sets the value relative to other currencies on a daily basis, and this system, combined with government control of interest rates, tight restrictions on capital flows, and close regulation of the financial sector, enables the South Korean government to control movement in the exchange rate without the need to buy and sell its currency on foreign exchange markets.

In order to better understand how trade between the Asian NICs and the United States would be affected by further currency appreciation, we contracted with Data Resources to simulate the trade impacts of a hypothetical 10 percent appreciation in each of the currencies. The combined U.S. trade deficit with Taiwan, South Korea, and Hong Kong in 1987 was $35.4 billion and in 1988, $29.2 billion. Assuming a 10 percent nominal appreciation in each of the three currencies, the simulation showed a reduction in the U.S. trade deficit with the three countries of $2.7 billion in 1989 and $3.5 billion in 1990. The overall U.S. trade deficit would likely decline by less than these amounts because imports from other countries would become more competitive and replace imports from Taiwan, South Korea, and Hong Kong.

The major conclusions of our study can be summarized as follows:

First, Taiwan and South Korea have acted to prevent their currencies' values from reflecting their economic strengths. Under carefully managed floating exchange rate regimes, their officials have been reluctant in the past few years to allow faster appreciation of their currencies in an effort to maintain current account surpluses. Since 1986, both Taiwan and South Korea have allowed significant appreciations of their currencies against the dollar, but not enough to satisfy U.S. objectives. However, changes last month in Taiwan's foreign exchange market operations appear to make the value of the New Taiwan dollar more market oriented and there was a significant appreciation of the currency. Hong Kong has maintained a fixed exchange rate since 1983, allowing its economy to adjust to changes in its overall trade balance through, inflationary effects. This alternative has been rigidly adhered to by Hong Kong in order to maintain economic stability during the politically sensitive reversion of sovereignty to the People's Republic of China in 1997.

Second, the results of the GAO/DRI simulation show that the appreciation of local currencies in Taiwan, South Korea, and Hong Kong may modestly reduce U.S. trade deficits with these countries.

Third, and last, more than just exchange rate changes are needed to reduce the U.S./Asian NIC trade imbalance. Further liberalization of restrictive trade barriers and macro-economic changes that will increase domestic consumption in Korea and Taiwan, when combined with currency appreciation, would be effective in addressing the inherent bilateral trade imbalance problems. Because Hong Kong has an open economy, a mechanism for adjusting to international trade and payments imbalances, and only a small current account surplus, appreciation of the Hong Kong dollar is not essential.

Mr. Chairman, this concludes my summary comments and we will be happy to try to respond to any questions you may have later.

[The prepared statement of Dr. Mendelowitz appears in the appendix.]

Senator BAUCUS. Thank you, Mr. Mendelowitz.

Next, Dr. Williamson.

STATEMENT OF JOHN WILLIAMSON, PH.D., SENIOR FELLOW, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Dr. WILLIAMSON. Thank you very much, Mr. Chairman. I am very happy to be here this morning.

I start off in my written testimony by discussing the criteria by which one should judge exchange rate policy and whether a currency is being manipulated in the sense of the Omnibus Trade Act, and the definition that I adopted there, deliberate undervaluation, is, I think, very close to the one that you suggested this morning in your introductory comments when you spoke of artificially undervalued currencies as the critical element that one is looking for.

To my mind, the critical element there is undervaluation rather than floating versus management of a currency. After all, among the Group of Seven currencies nowadays there is a substantial element of management as opposed to free floating, and so if one was putting the focus on that, it is not at all clear that the East Asian currencies are the only ones that one should be pointing the finger at.

So then one goes on to ask: what does one mean by undervaluation in this context? I think that it is fairly clear that it is a currency value which is so cheap as to generate a surplus more or less permanently, a surplus on current account in the medium run even when the economy is at full employment.

I think it is important to note in that context that the criterion there is one of the multilateral balance of payments position rather than the bilateral balance of payments against a particular country, even the United States. I think that if the United States got into the business of trying to enforce bilateral balance against each of its trading partners, it would be doing itself, as well as each of them, a great disservice by interfering with inherently efficient multilateral trade. In the case of the East Asians, for example, they have to import very heavily fuel and raw materials. That means they need a surplus in manufactures and the United States, and for that matter Europe, are natural areas for them to be in surplus with. So multilateral balance, I believe, is the criterion one should look for and not bilateral balance.

The other problem, of course, in defining an undervalued currency is to ask what is a reasonable balance of payments position. One certainly should not assume that every country ought to try and be in exact balance every year or even in the medium run. It is natural and reasonable to have some capital flows in the system, but I argue that even on that criterion there is no question that the surpluses of the East Asians in recent years have been far too large, either for their own good or for the good of the rest of the trading system.

The next part of the paper shows some simulations which are intended to be nearly comparable as possible to those that have been offered to you by the General Accounting Office and just described by Mr. Mendelowitz. Although they are not directly comparable for several reasons, and I think all the reasons suggest that our simulations should have come up with bigger effects, nevertheless, the scale is so substantially larger that I would regard the figures that were just given to you by Mr. Mendelowitz as on the low side. If anything, I would expect substantially larger effects of exchange rate changes, though I would not want to suggest that our figures were particularly accurate either.

The final part of the written testimony attempts to evaluate where we are now in each of the countries and contrasts that with the situation just 2 years ago in April 1987 when Bela Balassa and I completed the study on these three currencies, along with Singapore. We concluded that at that time all three of them were significantly undervalued and that, certainly in the cases of Korea and Taiwan, that had come about as a result of a deliberate policy of pegging to the dollar over the previous 2 years when the dollar had fallen from its peak in early 1985.

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Updating since then, in Hong Kong there are, of course, no trade or exchange controls, but there is a fixed peg to the dollar and that meant that Hong Kong got very significant competitive gains between 1985 and 1987, but that those have been eroded more recently because inflation has begun to get hold in Hong Kong. That is exactly what one would expect in a laissez-faire economy with a fixed exchange rate and a monetary policy rule that goes along with it. I myself regard that as poor policy because it is excessively inflationary, but I do not see that it is any sort of threat to the rest of the world.

In the case of Korea, one has had since then substantial import liberalization, substantial appreciation, and one also has very rapidly growing consumption. One has, in fact, an inflationary boom developing with domestic demand now growing very rapidly. The result was, however, that the balance of payments surplus rose to a new peak last year, but it has eroded very substantially in the first quarter of this year, and I think that that is what one would expect as a consequence of the policy actions that have been taken recently. They have, in fact, accomplished a larger real appreciation than Balassa and I recommended in our study, or than Cline had in his recommendations. So that, while Korea is clearly going to continue to need a trend appreciation, I think that there is no clear evidence that at this stage the Korean won is undervalued as against that trend.

I come to very similar conclusions in the case of Taiwan. They started off the adjustment process much sooner, and therefore, there is much clearer evidence of its effects. They had a substantially lower trade deficit already last year and the adjustment process does appear to be continuing. They also, incidentally, got less inflation in the process and did more through currency appreciation which I think was wiser of them. So that I agree very much with Mr. Mulford's conclusion as regards Taiwan, but I was surprised at the sharpness of the distinction that he drew between Korea and Taiwan because my assessment is that, while Taiwan started the process much sooner, Korea has acted fairly vigorously more recently and that also is paying fruit in terms of adjustment.

Thank you.

[The prepared statement of Dr. Williamson appears in the appendix.]

Senator BAUCUS. Thank you, Dr. Williamson.

We see we have five doctors up here now.

Dr. Bergsten, you are next.

STATEMENT OF C. FRED BERGSTEN, PH.D., DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Dr. BERGSTEN. Maybe too many doctors, Mr. Chairman.

I want to comment only on Korea—drawing on a visit I just paid to Korea about 2 weeks ago—to supplement Dr. Williamson's remarks, and then, if I have time, draw a couple of broader implications of your topic today for U.S. policy.

I would start by underlining my credentials as an exchange rate hawk with respect to Korea, and to Taiwan as well. When I paid an extensive visit to Korea in the summer of 1986, I think I was the first person to raise the issue, both in Korea and here, that the country was about to start running large surpluses and therefore was going to have to accept, indeed engineer, a large rise in the value of its currency. That caused a big stir in Korea, as you might imagine, and later Secretary Mulford, when he and his colleagues launched their initiatives, cited some of the work that I and my colleagues at the Institute had done to justify that approach.

Senator BAUCUS. I imagine somewhat because of the provision of the Trade Bill, too.

Dr. BERGSTEN. That probably had a little bit to do with it. I think they had several impetuses. It was also right after the Plaza Agreement, when the Treasury had started to move on currency misalignments with the industrial countries and later on those with the Asian NIC's.

We were, of course, right. Korea did become a large surplus country and did eventually have to start adjusting its exchange rate substantially.

On my recent visit I reached the conclusion that the Koreans had, at least for the moment, gone about far enough in raising the value of their currency, and therefore I disagree with my esteemed successor, Dr. Mulford, over what Korean policy should now be. The Korean surplus has declined dramatically. Wages are rising at about a 25-percent annual rate for the third consecutive year. There has been extensive import liberalization. All the models that we have run show that the current Korean exchange rate offers good promise of bringing Korea's surplus down to a very low level, or possibly even eliminating it.

So my conclusion—and I could go into great detail on the Korean economy now if you want—is that for the moment we should be satisfied with the appreciation of the Korean won. We should clearly continue to monitor it closely. We want to see if the improvement we have witnessed so far will be sustained. But for the moment we should hold our fire, watch the success in reducing their surplus continue, as I am quite confident it will through the remainder of this year, and then, if it stalls out or goes into reverse later, readdress the issue in the future.

I would, however, echo a point that Dr. Williamson made, which is very important with regard to Korea, but also for Taiwan and for Japan. Over the long run, productivity growth in these countries is going to be considerably faster than in the United States or most of the rest of the world. That will not be fully——

Senator BAUCUS. I am sorry, productivity growth greater where?

Dr. BERGSTEN. Than here in the United States or in Europe or most of the world.

Senator BAUCUS. Historically or in the future?

Dr. BERGSTEN. I am predicting in the future as well. I think their productivity growth will continue to be faster, and therefore——

Senator BAUCUS. I am sorry, faster where?

Dr. BERGSTEN. I am sorry. Productivity growth in Korea, Taiwan, and Japan——

Senator BAUCUS. All right. I am sorry. I understand.

Dr. BERGSTEN [continuing]. I think will be considerably faster than in the United States or in the rest of the world.

Senator BAUCUS. I agree. That is why I wanted it repeated.

Dr. BERGSTEN. Right. It is a point you made in your questions, and I think it suggests that over time the exchange rates of all those currencies will need to rise modestly, but fairly steadily, against the dollar to avoid their reverting large trade surpluses. If their wages also increase very rapidly for the indefinite future, that is the other way, of course, to avoid their developing new competitive gains. My guess is that they will not want to pursue that course. It would mean a lot of inflation, and so my strong suspicion is that even if these currencies are now more or less at equilibrium levels, and if further trade developments over the next 2 years support that suspicion, we should still maintain some surveillance and pressure to make sure that these countries keep their rates rising over the long run in order to avoid renewed surpluses in their economies.

There are two or three implications of all of this for broader U.S. policy. One addresses a question you raised when you were quizzing Secretary Mulford. I think we have to link our trade and monetary policies very closely for a simple reason.

Changes in the exchange rate, as Secretary Mulford said, are really the dominant element affecting overall trade balances. We have to challenge individual trade barriers in an aggressive way, no doubt about it. But when countries respond by letting their currencies rise or, in exchange rate regimes of this kind, actually by pushing their currencies up, they should be rewarded. If we do not reward them for satisfactory behavior, which in my view means moving them very close to underlying balance, then what incentive do other countries have to take positive steps? When we make a Super 301 designation or any other trade policy decision, we must take into account positive steps undertaken by those other countries. To do otherwise, it seems to me, runs counter to our whole international negotiating strategy.

Second, to underline a point that John Williamson made, you have to think of currency manipulation in terms of whether a currency is under or overvalued. Think of the U.S. experience in the first half of the 1980's. The United States did not manipulate the dollar. It let it fluctuate freely in the market, and the result was a 50-percent overvaluation and a massive trade deficit, and the United States became the world's largest debtor country. That was the biggest disaster of American exchange rate policy in the history of the Republic. So the issue is not whether you intervene or manage or not; indeed, you may want to manage.

The final point, in focusing today on Korea and Taiwan, is not to lose sight of the major-currency issues. The dollar has been going up, and that is renewing the adverse effect on our trade balance. The Japanese surplus is rising again. The German surplus keeps going up. The Treasury in its recent report, which focused on Korea and Taiwan, did not address adequately the renewed deterioration of the U.S. trade balance, and the renewed rise of surpluses in Japan and other industrial countries. I hope the Committee and the Congress as a whole will focus on that issue very carefully as you continue your implementation and monitoring of the Trade Act of last year.

[The prepared statement of C. Fred Bergsten, Ph.D., appears in the appendix.]

Senator BAUCUS. Thank you very much, Dr. Bergsten.

I am a little bit surprised—and frankly, a little bit confused—with the degree to which you make a distinction between the currency exchange rate changes and trade barriers. It seems to me we have to ask ourselves what is the reason for an undervaluation of a currency. There are all kinds of reasons that may occur.

And second, I think it is important to look at the reasons behind a current account surplus. There are all kinds of reasons why a country—such as Taiwan or Korea, for example—may have current account surpluses. I am frankly surprised to hear you say that if a country, hypothetically Korea, were to address its currency undervaluation, managing appreciation of the Korean won, so that the currency is no longer as undervalued as perhaps it once was, that that country should be rewarded, and therefore, the United States should not, as I read between the lines, commence a Super 301 or it should not address trade barriers. It seems to me that a current account surplus could be due in part to undervaluation of a currency. It could also be due in part to trade barriers, and there may even be other reasons.

Dr. BERGSTEN. Right.

Senator BAUCUS. And an analogy, although not a good one, comes to mind is in contract law is that when someone has a contractual obligation to do something, you cannot renegotiate a new contract only on the basis that one party gives up a contractual right where the first party does not give up a contractual right. That is to say, if a country is undervaluing its currency through exchange rates that that should be addressed and that trade barriers are a separate matter that should also be addressed.

Could you explain more persuasively why, and I do not know if I will agree with you, but explain more fully the reasons why as I hear you that the United States should "back off" on trying to address trading barriers if, say, Korea in this case lets its currency appreciate?

Dr. BERGSTEN. Let me first clarify because, under the pressure of your time limits, I was speaking too graphically and too cryptically.

Senator BAUCUS. I apologize.

Dr. BERGSTEN. No, I was not clear.

I have also been very hawkish with Korea and Taiwan, as with Japan, on the need to liberalize their trade barriers. Indeed, in my written statement I point out that they have still some distance to go in terms of trade liberalization.

However, one reason that you are correct in reading between the lines is because Korea has, in addition to a lot of currency appreciation, also accomplished a lot of trade liberalization. That is true for Taiwan as well. Both countries have implemented an extensive series of reductions of trade barriers, both tariff and nontariff, as well as let their currencies rise.

I am in complete agreement with you that one has to move on both the currency and the trade barrier fronts with both those countries. In fact, the study that John Williamson did a couple of years ago stressed heavily the need for import liberalization, and the argument was made that countries that were running surpluses, as they were, really had no business at all maintaining the kind of trade barriers they had.

I would again, however, give a good deal of credit to both of those countries for having responded, belatedly but nevertheless now pretty extensively, with trade liberalization programs. As I say in my statement, they have not gone far enough. They still have some barriers. They are now running into the kind of domestic political difficulties that we have here and that all countries have. But in terms of trade liberalization as well as currency appreciation, I would give both Korea and Taiwan a lot of credit; it is only because they have done both that I would come to the kind of judgment I did.

Senator BAUCUS. I hear you.

Dr. BERGSTEN. My main point was a negotiating point, actually: since both those countries have achieved an extensive amount of trade liberalization and currency appreciation, those things ought to be taken into account when the question of section 301 designation comes up. Frankly, if you do not reward those countries that have probably done more than any others on both fronts together, what signal are you sending to other countries about the consequences of responding to U.S. demands?

Senator BAUCUS. Aren't there other ways to reward countries? First of all, I am ~~not~~ entirely convinced one should be rewarded for not doing something that something should not do.

For example—and again, do not hold me to this analogy, but this comes to mind—someone commits a crime, that person is punished. By analogy, from what you say, those other American citizens or other country's citizens who do not commit crimes should be rewarded, or if somebody stops committing a crime that he should get a payment. The government should reward him.

I just think frankly that if a country is undervaluing its currency improperly, whatever that means, that that country should cease and desist, and if we do reward that country, although I am not convince that we should, we can do it in other ways. There are an infinite number of ways we can do so. All kinds of ways come to mind. But as I hear you further, you seem to be, in fact, saying that when USTR looks at Korea in trying to decide whether to name Korea or not that the USTR should look at the trade liberalization that Korea has, in your view, already undertaken in deciding whether or not to cite Korea. And you also tend to think that the USTR should additionally look at currency changes as appreciation of the Korean won.

Dr. BERGSTEN. I do think that.

Senator BAUCUS. I tend to disagree with that frankly. I think that because current account surpluses can be caused by all kinds of reasons, trade on one hand or currency exchange rates on the other, that we ought to keep a eye on the ball in each of the areas for frankly liberalized trade as much as we would like to.

Dr. BERGSTEN. To stick to the trade liberalization issue for the moment, with all due respect I do not like your analogy because I think——

Senator BAUCUS. I did not say it was a good one.

Dr. BERGSTEN. Well, I think in the trade policy area we are all sinners. Everybody has barriers.

Senator BAUCUS. Yes. So do we.

Dr. BERGSTEN. Right. And so what you want is liberalization everywhere, and when countries do liberalize, I think they should get credit for it. Compare, for example, Brazil, with which we have a lot of trade problems. Brazil has its own debt problems, which are also an overriding factor there, but has it liberalized to anything like the extent the Asian countries have? What is the message to Brazil if we do not give some kind of reward—and I agree, it can be of different kinds—to countries that have moved strongly forward.

Senator BAUCUS. I hear you. I hear.

Dr. BERGSTEN. I think that is a crucial point.

Senator BAUCUS. I want to let Dr. Williamson and Dr. Mendelowitz comment on this subject. That is, the degree to which we should reward Korea or Taiwan for any actions they have taken to appreciate their currency when we try to decide whether to, say, name Korea or Taiwan to Super 301.

What is the importance of this distinction between trade barriers and currency undervaluation?

Dr. MENDELOWITZ. I think that it is a mistake to separate considerations of trade barriers from considerations of exchange rates and in turn from considerations of the level of domestic economic activity in these countries. Surpluses, structural surpluses, can be caused by undervalued currencies. They can be caused by macroeconomic policies in these countries. They can be caused by trade barriers, and I think that it is unfortunate that these issues in the negotiating process are taken individually.

I think it, in a sense, reflects the way our government separates out responsibilities by different agencies. Treasury negotiates on exchange rates. It does not negotiate on trade barriers. Commerce and USTR negotiate on trade barriers. They do not negotiate on exchange rates because Treasury jealously guards its prerogatives with respect to exchange rates. I think that what we need to do is take a holistic approach to these issues and to look at exchange rates and trade barriers and macro-economic policies all at the same time.

If, for example, there is more liberalization with respect to trade barriers, you need probably less in the way of currency appreciation. If you do not have liberalization with respect to trade barriers, you are going to need a much larger appreciation to overcome those barriers in effect if you are looking for some kind of balance.

Senator BAUCUS. That does not excuse the trade barriers.

Dr. MENDELOWITZ. No, no. It does not excuse the trade barriers——

Senator BAUCUS. Does not "excuse."

Dr. MENDELOWITZ. Does not excuse the trade barriers. I think that those are issues which all have to be dealt with on their own merits.

Senator BAUCUS. Dr. Bergsten, could you explain for me the essential difference you have with Secretary Mulford with respect to Korea? I do not quite understand the difference.

Dr. BERGSTEN. I think the difference is only in how we read the current figures in Korea as an indication of the future trend. As I quickly read Secretary Mulford's statement, he acknowledged that there has been a very sharp decline in the Korean surplus, but he thinks it is too early to conclude that their surplus is coming down to a lower level.

Admittedly it is a matter of judgment, and I said in my statement there are some seasonal and temporary factors involved in the enormous decline in the Korean surplus in the first 4 months of this year. I talked to almost everybody in Korea about that—businessmen, private economists, all the top people in government—and there is an enormous range of views as to how far their surplus is coming down. But everybody agrees it is coming down a lot. I think it will probably be cut about in half this year. It was $14 billion last year. I think it will come down to $7 billion or $8 billion and will continue to fall in the future. That estimate is based on the extensive analyses that John Williamson and Bill Cline have done at my Institute, involving economic modeling of the past record and the prospects for Korea's trade.

Senator BAUCUS. Is it going to continue to come down after May 30th?

Dr. BERGSTEN. Oh, yes. In fact——

Senator BAUCUS. If neither Korea or Taiwan are named?

Dr. BERGSTEN. Well, as Dr. Mendelowitz just pointed out, the Treasury is going to keep after them, and Secretary——

Senator BAUCUS. But May 30 will have passed.

Dr. BERGSTEN. Excuse me?

Dr. MENDELOWITZ. I did not predict that Treasury was going to stay on them after May 30.

Dr. BERGSTEN. What Dr. Mendelowitz said was that Treasury will pursue its path and the trade people will pursue their path, and another report is required from Treasury in October on how Korea and Taiwan are going. So you have plenty of pressure on the Treasury to keep going, and Secretary Mulford certainly indicated that he is going to keep the pressure on Korea and Taiwan.

I do not think that is the problem, frankly. You can take from Secretary Mulford's testimony this morning clear evidence that Treasury is going to keep putting pressure on Korea. I am, in fact, raising the question of whether that is correct policy at this point. In answer to your question, my judgment based on a lot of first-hand observation in Korea 2 weeks ago, but also the underlying analysis that now two different studies at our Institute have developed, is that the surplus is going to come down quite a long way.

Senator BAUCUS. I am sorry.

Dr. BERGSTEN. I would underline, however, that we have to continue to monitor this progress closely. If it stalls out or the surplus goes back up when it is still too high, then resume the discussions.

Senator BAUCUS. Yes, but my question, Fred, was I know the Secretary will continue to negotiate, but I am wondering what incentive those other countries will have in moving further after May 30th, say, if they are not named.

Dr. BERGSTEN. Well, I noticed that Secretary——

Senator BAUCUS. That is my concern.

Dr. BERGSTEN. Yes. Well, I notice——

Senator BAUCUS. It is a leverage. It is a leverage.

Dr. BERGSTEN. It is a fair question. Let me just say as an aside, I think it is in the Koreans' interest not to have their currency undervalued. As Dr. Williamson pointed out, that may be one reason they are experiencing these big wage demands and strikes. They have kept their currency down. It has harmed the growth of real incomes in Korea. If they had moved earlier, as Taiwan did, maybe they would now be having less trouble. I think they should let their currency rise for their own reasons.

From the negotiating standpoint, Secretary Mulford took some pride, I thought, in his remarks this morning that Treasury's efforts, driven by the Congress' requirements in the Omnibus Act, have had a big impact in both Taiwan and Korea in bringing about appreciation of their currencies over the last year.

Senator BAUCUS. Yes.

Dr. BERGSTEN. That pressure will continue. Those reports are due every 6 months.

Senator BAUCUS. I hope so. I authored that provision in the bill.

Dr. BERGSTEN. I know you did.

Senator BAUCUS. It works.

Dr. BERGSTEN. I know you did, and at the end of my statement I applauded, once again, the Congress and you personally for having done that and for monitoring it effectively right now. I simply said, monitor it vis-a-vis the yen and the deutsche mark too because that is even more important.

Dr. MENDELOWITZ. Mr. Chairman, I think it is fair to say that in the case of Korea and Taiwan these are both economies that would like desperately to avoid being named as Super 301 countries.

Senator BAUCUS. I guess that is safe to say.

Dr. MENDELOWITZ. And even though exchange rates and trade barriers are sort of in separate loops under the trade law, I am sure that part of the flexibility shown and the improvement shown on exchange rates no doubt is in part reflective of this effort to try to avoid Super 301 designation.

Senator BAUCUS. I think that is correct. I agree with that. I think that is fairly clear.

Dr. Bergsten, isn't it true though that if along with the wage rate increases in Korea their productivity increase, and productivity increases greater than those in the United States, to some degree diminish or cancel out the increases in the wage rates?

Dr. BERGSTEN. Yes, absolutely.

Senator BAUCUS. And so, when we hear some from Korea say, as they often do, "Well, gee, look at our wage rates. Therefore, our currency is not undervalued," that we should also recognize the productivity.

Dr. BERGSTEN. Absolutely. But one needs to look at the change in unit labor costs. Even Korean productivity growth, as impressive as it is, is not 20 to 25 percent a year, which is what those wage increases have been and what it looks like they will continue to be.

Senator BAUCUS. Yes.

I apologize if I have this incorrect. Do you feel, therefore, that for the moment both the New Taiwan dollar and the Korean won are about the right level?

Dr. BERGSTEN. I think they are both at about the right level. One cannot be too precise on this. Our analyses in fact suggest that Korea is a bit closer to a lasting equilibrium level than Taiwan. But given the lack of precision one should ascribe to these estimates, I would say they are both pretty close at this time.

Senator BAUCUS. If it is true that the potential naming of either of these countries under 301 is in fact leverage, what do you recommend we do after May 30th if in fact neither country or one of the two countries is not named? What leverage do you think we should come up with so that we can continue the appropriate movement?

Dr. BERGSTEN. Well, Mr. Chairman, as I understand the 301 process, it is an ongoing one. May 30 is the initial date for designating priority countries and priority practices. But every year, as I understand it, the USTR has to do the same thing.

Senator BAUCUS. Yes, what do they do for those 365 intervening days?

Dr. BERGSTEN. Well, I think they should maintain the pressure on the issues that remain, and there are many. They should point out that a reward was given for good behavior this time, but that a reward for good behavior will not be possible next time unless the additional umpteen items are addressed. I think that is at least as strong a negotiating stance as having designated a country under section 301.

If you designate a country, the people in that country who took the hits on those products that were already liberalized are then doubly unhappy, and the government is subject to criticism for having put them under the gun. The government might then say, and I certainly heard this in Korea, "We never should have made those concessions. If we were going to get hit anyway, we should wait for the hit, avoid concessions, and then negotiate later."

In fact, some Koreans are saying, "We must have been pretty naive to make these advance concessions if they were going to hit us anyway." I really think you run a risk of a perverse outcome if you do not reward positive actions. I am not coming to a bottom-line judgment explicitly, because I do not feel I know enough of the details, but I think there is an important principle of reward.

On your questions, I think you put yourself in a strong position for the next year if you reward a country for having taken steps now. You make very clear that they have to do more to avoid designation again next year. You start negotiating now. You put it into your overall strategy, and proceed apace, and then if they fail to respond, next year you hit them. Like any deterrent, Mr. Chairman, it is better kept in the closet than applied, because once you apply it, it may not be as effective as the threat hanging out there.

Senator BAUCUS. All right.

Does anyone else want to comment; that is, has anyone said anything so outrageous that it deserves a response?

Dr. Williamson?

Dr. WILLIAMSON. No, I have nothing to add.

Senator BAUCUS. Dr. Mendelowitz?

Dr. MENDELOWITZ. I think that the lesson we have learned from this trade law is that action-forcing mechanisms, such as drop-dead dates by which critical decisions have to be made, play an important role in moving us along in achieving our objectives.

Senator BAUCUS. Absolutely. I totally agree with that.

Gentlemen, this has been very helpful. I think it is important to realize that, as Dr. Mendelowitz said, the provisions in the bill have helped make some progress here, and I think the work of some of you, as well as that of the government, as well as the provisions of the Trade Bill, have encouraged greater appreciation of some of these currencies that we do think are manipulated in an unfair and improper way.

It is also clear that, in my view, they have further to go. We have more work ahead of us, and we have to continue to try to find solutions so that those currencies are properly aligned.

Thank you very much. I appreciate your testimony.

The hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was concluded.]

APPENDIX

Alphabetical Listing and Material Submitted

Prepared Statement of C. Fred Bergsten

THE KOREAN WON

During a visit to Seoul in July 1986, I became virtually the first person to (a) suggest that Korea was in the process of becoming a sizable surplus country and (b) would therefore *inter alia* have to engineer a substantial appreciation of the won to restore equilibrium in its external position. There was nearly unanimous rejection in Korea of both my forecast and my policy prescription, both of which of course turned out to be correct.

A subsequent Institute study published in June 1987, *Adjusting to Success: Balance of Payments Policy in the East Asian NICs* by Bela Balassa and John Williamson, concluded that the won would need to rise by a trade-weighted average of 10-15 percent. This implied a needed rise of about twice that amount against the dollar.[1]

Korea in fact ran current account surpluses of about $5 billion in 1986, $9 billion in 1987 and $14 billion in 1988. Indeed, its surplus in 1988 roughly equalled that of Taiwan—after having been half as large, or less, in the two previous years. As a result, the won was permitted to appreciate by about 30 percent against the dollar—the top of the range called for in our study in 1987. It was the *only* important currency to rise against the dollar in 1988, by about 16 percent, when the yen and surplus European currencies were again falling instead.

As indicated in John Williamson's testimony this morning, a new global trade model developed at the Institute by William Cline suggests that the present rate of the won could push the Korean current account back into substantial deficit by 1992. That study concludes that the won is the only currency of a major surplus country—certainly not the yen or PM—to appreciate sufficiently to offer promise of restoring equilibrium in its country's external position. (Taiwan is getting close, particularly after the further sharp rise in the NT$ which occurred last week.)[2]

I visited Seoul again on April 19-21, and would like to share my observations from that trip with the Subcommittee. The central development is a dramatic reduction of the Korean surplus in the first four months of 1989. I believe that seasonal and other temporary factors account for an important part of this swing. Nevertheless, I expect a substantial fall in the surplus for the full year 1989—perhaps by $6-7 billion.

This would represent a cut of about 50 percent from the peak surplus reached last year. It would amount to at least 5 percent of Korean GNP (in real terms) and thus substantially reduce their overall economic growth for the year. An expansion of domestic demand that would be quite sizable even by Korean standards would be needed to keep the economy going, even at a rate considerably less than the 12 per-

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[1] See Bela Balassa and John Williamson, *Adjusting to Success: Balance of Payments in the East Asian NICs*. Washington: Institute for International Economics, June 1987.

[2] See William R. Cline, *American Trade Adiustment: The Global Impact*. Washington: Institute for International Economics, March 1989. I drew heavily on the earlier stages of that study in developing my own comprehensive proposals for US international economic policy, presented in *America in the World Economy: A Strategy for the 1990s*. Washington: Institute for International Economics, November 1988.

cent achieved in each of the last three years[3]—though some decline in growth is desirable to check the buildup of inflationary pressures.

We cannot know at this time how far the Korean adjustment will go, nor how sustained it will turn out to be. Indeed, the surplus was still large in late 1988 and the Koreans themselves have consistently underestimated its magnitude. Moreover, Japan's surplus began to rise again after only one year of decline in dollar terms and two years of decline in real terms, and there have been a few tentative signs that Taiwan's adjustment has slowed or stalled out (though the authorities there have adopted an explicit target of cutting their surplus by an additional 10 percent annually).

However, recent developments present important evidence that the appreciation of the won that has already taken place—along with the rapid liberalization of imports and substantial wage increases of the past two years, both of which have similar effects to won appreciation—may have placed Korea on the path to current account equilibrium. In particular, it looks like wages will be rising by at least 20–25 percent annually in Korea for at least another year or two. Indeed, some respected Korean economists believe that the won has already overshot on the upside. I would therefore recommend that the United States and the International Monetary Fund not push Korea for further currency movement at this time.

The situation, however, should be kept under close review. If the decline in the Korean surplus stalls before reaching a much lower level (or my preferred target of zero) or goes into reverse, a renewed series of adjustment efforts will have to be initiated.

It is also important, especially in Korea itself, to recognize the probable need for steady real appreciation of the won over the longer run. It is quite likely that productivity growth in Korea will continue, for some time to come, to exceed productivity growth in most other countries—certainly the United States—by a substantial margin. This raises the prospect of renewed growth in Korean surpluses in the future unless there is a continuous adjustment effort, which would almost certainly include appreciation of the won in real terms.

Indeed, steady currency appreciation is one very healthy way to translate productivity growth into higher national income and standards of living. Korea's per capita income has been growing rapidly but is still only about $4,000—about one-fifth the level of the advanced industrial countries. One might even venture a guess that Korea's current labor disruptions, at least to the extent they are driven by demands for higher wages, might have been muted if the won had been allowed to rise sooner. The Japanese story of the past twenty years, which Korea should seek to avoid for both internal and external reasons, is a series of growing trade surpluses deriving from rapid increases in productivity which were not reflected in subsequent yen appreciation.

THREE IMPLICATIONS FOR US POLICY

Three implications for US policy derive from this analysis. One is the importance of effectively linking our trade and international monetary policies. As the Korean case shows so clearly, there are tradeoffs between import liberalization and currency appreciation in the adjustment strategies of the surplus countries. We must be able to set priorities among our own demands on others if we are to develop a coherent national position and pursue our goals successfully.

In particular, we need to be able to provide trade policy rewards for good monetary performance abroad (and vice versa) For example, the substantial appreciation of the won (along with Korea's extensive, though still inadequate, trade liberalization) should be an important consideration in determining whether Korea will be designated as a "priority foreign country" under the "Super 301" provision of the Omnibus Trade Act. Conversely, the Treasury Department needs to take account of noncurrency developments, such as import liberalization and large wage increases, in determining whether countries are "manipulating" their currencies within the meaning of the Act.

Second, as stressed by my colleague John Williamson, we should recognize that virtually every country manages its exchange rate. The United States and the Group of Seven leading industrial countries certainly do so, with global attention

[3] Such developments would roughly parallel the experience of Taiwan in 1988, where the surplus fell by a like amount—and by an ever larger share of GNP because Taiwan is a smaller economy. Taiwan's trade deterioration was compensated by domestic demand expansion of 16–17 percent, however, and thus economic growth remained highly buoyant.

and impact since the Plaza Agreement in September 1985 and the Louvre accord of February 1987.[4]

Indeed, the major disaster of American currency policy in the entire postwar period occurred during 1981-84 when the Regan-Sprinkel Treasury *refused* to manage the currency. Coupled with the huge growth in the budget deficit during that period, the result was massive overvaluation of the dollar and the huge trade deficits whose legacy we are discussing today.

The exchange rate and the interest rate are the two most important prices for virtually every country. No one would suggest letting interest rates respond wholly to market forces; that is why we have a Federal Reserve System. Likewise, we have learned that "market forces" can push currencies far from their underlying equilibrium values for extended periods of time. Hence they too need to be consciously managed, always in keeping with long-term market tendencies but avoiding slavish devotion to the ideological shibboleth of governmental nonintervention.

At the same time, it is clear that countries do on occasion try to capture a competitive edge for their economies by intervening in the currency markets in a "manipulative" manner, directly or nondirectly. Japan did so for a period in 1976.[5] Several of the Asian NICs did so in 1985-86, remaining pegged to the dollar as it declined sharply against the currencies of virtually all other important trading countries.

To be fair, some of the NIC currencies had also risen with the dollar during the previous years and thus *lost* price competitiveness. Korea felt that the continuing *deficits* in its trade and current account positions in 1984-85, and the foreign debt of almost $50 billion it had accrued at that time, in fact required the adoption of policy measures to *improve* its external position.

Such instances—including the US case of 1981-84—remind us that countries occasionally adopt exchange rate policies that deviate from their own national interests (and those of the world economy as a whole). It is therefore essential that these policies, despite their sensitivity for markets, be subject to open policy debate within and among countries. My third policy observation is that the case of Korea (and Taiwan) over the past year amply demonstrates the desirability of Section 3005 of the Trade Act, and I was delighted to see Secretary Brady and Under Secretary Mulford applaud the legislation in their testimony to the Senate Banking Committee last week.

I thus want to close by again congratulating the Congress for its leadership in both instituting that legislation and in monitoring its implementation through hearings such as this. I would note, however, that the trade and current account deficits of the United States itself are rising again. The Japanese and German surpluses are going up. We should certainly concern ourselves with Korea and Taiwan, but their imbalances are much less important than those of the Big Three—and are at least headed in the right direction. The latest Treasury report under Section 3005 fails to adequately address the renewed growth in the imbalances of the Big Three, and its implications for global financial stability and the world trading system.[6] The Congress will be derelict in its monitoring of the Act if it fails to address this central issue over the coming weeks and months, and I urge it to do so.

Prepared Statement of Allan I. Mendelowitz, Director

Mr. Chairman and Members of the Subcommittee: I am pleased to be here today to discuss with you our review of how currency exchange rates are determined in Taiwan, South Korea, and Hong Kong. These economies are commonly referred to as the Asian newly industrializing countries (NICs). In addition to examining the exchange rate regimes in each of these Asian NICs, we estimated the probable impacts of hypothetical appreciations of these economies' currencies on the U.S. trade imbalances with them and the implications for the overall U.S. trade deficit. Our study was undertaken at the request of the Chairman of the Senate Committee on Finance, Lloyd Bentsen, and the report was issued at the end of April.[*]

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[4] See Yoichi Funabashi, *Managing the Dollar: From the Plaza to the Louvre.* Washington: Institute for International Economics, May 1988.

[5] As exposed in my testimony of October 18, 1976 to the Subcommittee on International Economic Policy of the Joint Economic Committee (reprinted in *Managing International Economic Interdependence: Selected Papers of C. Fred Bergsten.* Lexington, Mass.: D.C. Heath and Co., 1977, pp. 69-71).

[6] A detailed analysis is in my *America in the World Economy: A Strategy for the 1990s.*

[*] *U.S. Trade Deficit: Impact of Currency Appreciations in Taiwan, South Korea, and Hong Kong* (GAO/NSIAD-89-130, April 1989).

RECENT TRENDS IN U.S. TRADE WITH TAIWAN, SOUTH KOREA, AND HONG KONG

The Asian NICs have run combined trade surpluses with the United States in the 1980s, growing from $4.9 billion in 1980 to $35.4 billion in 1987. The combined U.S. trade deficits with Taiwan, South Korea, and Hong Kong represented 21 percent of the total U.S. trade deficit in 1987. Despite an 18-percent drop in the U.S. trade deficit with these three NICs from $35.4 billion in 1987 to $29.2 billion in 1988, it continued to represent over one-fifth of the total U.S. trade deficit. The improvement in 1988 was attributable to trade deficit reductions with Taiwan ($4.8 billion) and Hong Kong ($1.4 billion); the deficit with South Korea remained virtually unchanged.

The sharp increase in the U.S. trade deficit with these three Asian NICs resulted from a rapid increase in U.S. imports from them while U.S. exports to them increased much more slowly. Imports from these three countries rose quickly, from 6 percent of total U.S. imports in 1980 to 13 percent in both 1987 and 1988. U.S. exports to the three NICs remained at about 5 percent of total U.S. exports between 1980 and 1986, but improved to 8 percent in 1987 and 9 percent in 1988.

Several factors have contributed to the U.S.-Asian NIC trade imbalance in the 1980s. Among these are (1) low-valued Asian NIC currencies relative to both the U.S. dollar and the Japanese yen, (2) systemic differences between the Asian NIC and U.S. economies (i.e., the NIC economies are export-driven, have high savings rates, and have protected domestic markets (except for Hong Kong) and the U.S. economy is domestic-demand driven, has a low savings rate, and has a relatively open market), and (3) historical trading patterns among the Asian NICs, Japan, and the United States.

ASIAN NIC INTERNATIONAL PAYMENTS POSITIONS

Although Taiwan, South Korea, and Hong Kong run trade surpluses with the United States, their individual current account situations differ. Between 1981 and 1987, Taiwan recorded steady increases in its current account surplus, reaching close to $20 billion in 1987. Its foreign exchange reserves approached $77 billion in both 1987 and 1988, second only to Japan. In 1988, Taiwan's current account and overall trade balance fell substantially (to approximately $12 billion) in response to slower export growth and a significant increase in merchandise imports. South Korea has had an overall current account surplus only since 1986. However, this surplus rose sharply in 1987 and, by the end of 1988, totaled $14 billion—surpassing Taiwan. South Korea possesses a rather large external debt, which totaled some $4 billion in 1986. The Korean government used its current account surplus to bring this debt level down to $32 billion in 1988. Hong Kong has had a small, stable current account surplus since 1983. Although Hong Kong has maintained a trade surplus with the United States in the 1980s, this surplus is fully offset by trade deficits with other countries, particularly Japan, resulting in a small overall trade deficit in recent years.

U.S.-ASIAN NIC POSITIONS ON EXCHANGE RATES

Since 1986, the U.S. government trade policy toward Taiwan and South Korea has emphasized currency appreciation and import liberalization as the means to reduce the U.S. trade imbalance with them. The U.S. Treasury, which is the lead U.S. agency in exchange rate negotiations, has maintained that the New Taiwan dollar and the Korean won have been kept undervalued against the U.S. dollar. Treasury has concluded that low-valued currencies are primarily the result of government administrative practices that manipulate the value of these currencies instead of allowing them to be more "market-determined" and reflective of the countries' underlying economic strengths. Treasury has also argued that higher valued currencies in Taiwan and South Korea would contribute toward multilateral efforts to resolve global current account imbalances. The U.S. government's position toward Hong Kong can be characterized as less forceful. The Hong Kong dollar is directly pegged to the U.S. dollar at a fixed rate and Hong Kong has one of the most open markets in the world. However, Treasury has indicated that it would like to see the Hong Kong dollar appreciate in conjunction with the currencies of the other Asian NICs.

In our overseas work on this study, we talked with a wide spectrum of public and private officials. Government officials in Taiwan and South Korea have argued for modest appreciations of their currencies against the U.S. dollar and at slower rates than desired by the U.s. government. They believe that their trade surpluses with the United States will improve as measures to liberalize their import barriers are implemented and the lagged effects of recent currency appreciations are realized. Hong Kong officials believe that no change in their exchange rate is necessary because of their open economy, existing adjustment mechanisms, and overall current account balance. Officials in all three NICs argue that macroeconomic imbalances in the United States—such as the large, continued budget deficits and strong consumer demand for imported products—have contributed considerably to the U.S. trade deficit.

EXCHANGE RATE MOVEMENTS IN THE ASIAN NICS

Between 1985 and 1988, the U.S. dollar depreciated against the New Taiwan dollar in nominal terms by 29 percent and against the South Korean won by 23 percent. The Hong Kong dollar has not departed significantly from HK$7.8 to US$1.00 since it was pegged to the dollar in late 1983. The value of these currencies can also be examined in real effective terms. This provides a better measure of changes in overall competitiveness because it considers cost-price relationships between a country and its trade partners and competitors.

The Morgan Guaranty Trust real effective exchange rate index shows that between 1980 and 1985 the New Taiwan dollar actually depreciated by 5.7 percent in real terms relative to its average for 1980-82 (the Morgan index base year). Similarly, the Korean won depreciated by 11.3 percent in the same time frame. Both currencies continued to depreciate in real terms in 1986 but appreciated in 1987 and 1988. However, even the nominal appreciations of the New Taiwan dollar and the Korean won in 1988 did not completely offset earlier depreciations of the currencies. Since the first of this year, the Korean won has strengthened against the U.S. dollar by 2.7 percent. The New Taiwan dollar has appreciated at a faster pace during 1989—some 11 percent as of this week, with the bulk of this movement occurring within the last month. The most recent 1989 Morgan Guaranty index shows the Korean won to be lower in real effective terms than its 1980-82 average, while the New Taiwan dollar has appreciated beyond its 1980-82 average.

The Morgan index shows that the Hong Kong dollar appreciated in real effective terms by 3.3 percent between 1980 and 1985. In both 1986 and 1987, however, it depreciated and, in real effective terms, it also remained at a value lower than its 1980-82 average in 1988. The most recent Morgan index shows the Hong Kong dollar strengthening in real effective terms but remaining below its 1980-82 average.

HOW EXCHANGE RATES ARE DETERMINED IN THE ASIAN NICS

Exchange rate systems of the three Asian newly industrializing economies fall into two categories—fixed (Hong Kong) and managed floats (Taiwan and Korea). Within these two systems, the governments exercise different degrees of intervention to counter market forces, with Hong Kong exercising the least control and South Korea the most.

The Hong Kong dollar is freely convertible with the U.S. dollar at a fixed rate. Hong Kong lets its economy adjust to changes in its trade balance through fluctuations in its money supply (and, consequently, price level) rather than through changing the value of its currency. In this system, a trade-surplus leads to an increase in the local money supply and inflation. The resulting higher prices make Hong Kong exports less competitive and should lead to a correction of the trade imbalance. Even though there are market mechanisms that maintain the fixed exchange rate, the Hong Kong government has intervened periodically in the foreign exchange market. During 1987-88, it bought U.S. dollars largely to counter an inflow of speculative funds attracted by the anticipation of an appreciation in the currency.

Taiwan made changes to its foreign exchange market operations on April 3, 1989. Prior to these changes, Taiwan's central bank used two government-controlled banks to intervene in the foreign exchange market on a near daily basis. The intervention was used to influence the daily closing rate of the New Taiwan dollar which, in effect, determined the next day's opening exchange rate. In some cases, the intervention smoothed out excessive fluctuations. In other instances, however, the intervention in effect prevented appreciation that would have otherwise occurred. Taiwan's recent changes to its foreign exchange system appear to allow the value of the currency to be influenced more by market forces. Yet, even under this system, heavy central bank intervention is possible and in a manner less transparent than under the old system. In the first month following Taiwan's changes to its foreign exchange market operations, the New Taiwan dollar appreciated against the U.S. dollar in nominal terms by 8 percent. A dramatic one day change between May 2 and May 3 accounted for almost 7 percent of this change.

The exchange rate for the South Korean won is not allowed to fluctuate freely on foreign exchange markets. South Korea's central bank sets the value relative to other currencies on a daily basis. This system, combined with government control of interest rates, tight restrictions on capital flows, and close regulation of the financial sector, enables the South Korean government to control movement in the exchange rate without the need to buy and sell its currency on the foreign exchange market.

POTENTIAL RESULTS FROM FURTHER ASIAN NIC CURRENCY APPRECIATIONS

In order to better understand how trade balances between these Asian NICs and the United States would be affected by further currency appreciations, we contracted with Data Resources, Incorporated (DRI), to simulate the trade impacts of hypothetical 10-percent appreciations in each of their currencies. DRI is a company specializing in econometric forecasting, and it closely monitors Asian economic and trade developments. Paying special attention to the trading relationships among the Asian NICs, Japan, and the United States, the DRI simulation assumed a 10-percent appreciation in each NIC currency during 1988. Because the impacts of exchange rate changes have time lags, the simulation extended through 1990.

Technical details associated with the simulations can be found in the report. However, it should be noted that these simulations assessed the impact of currency appreciation alone; thus, the results do not reflect changes in imports resulting from import liberalization efforts in Taiwan and South Korea.

The simulation showed that currency appreciations—in the absence of other structural reforms to liberalize import restrictions and strengthen domestic demand—could yield only modest results in reducing U.S. trade imbalances with South Korea and Taiwan. For Hong Kong—with its absence of import restrictions, exchange controls, or credit restrictions—currency appreciation could produce only minor changes in existing economic and trade patterns.

The combined U.S. trade deficit with Taiwan, South Korea, and Hong Kong was $354 billion in 1987 and $29.2 billion in 1988. Assuming a 10-percent nominal appreciation in each of the three currencies, the simulation showed a reduction in the U.S. trade deficit with the three countries of $2.7 billion in 1989 and $3.5 billion in 1990. The overall U.S. trade deficit would likely decline by less than these amounts because imports from other countries could become more competitive and replace imports from Taiwan, South Korea, and Hong Kong. As noted in our report, the simulation results are comparable to estimates made by many international trade economists, both in the United States and in the three Asian countries.

CONCLUSIONS

The major conclusions of our study can be summarized as follows. First, Taiwan and South Korea have acted to prevent their currencies' values from reflecting their economic strengths. Under carefully managed floating exchange rate regimes, their officials have been reluctant in the past few years to allow faster appreciation of their currencies in an effort to maintain current account surpluses. Since 1986, both Taiwan and South Korea have allowed significant appreciations of their currencies against the U.S. dollar, but not enough to satisfy U.S. objectives. However, changes last month in Taiwan's foreign exchange market operations appear to make the value of the New Taiwan dollar more market-oriented and there was a significant appreciation of the currency. Hong Kong has maintained a fixed exchange rate since 1983, allowing its economy to adjust to changes in its overall trade balance through inflationary effects. This alternative has been rigidly adhered to by the Hong Kong government in order to maintain economic stability during the politically sensitive reversion of sovereignty to the People's Republic of China in 1997.

Second, the results of the GAO/DRI simulation show that an appreciation of local currencies in Taiwan, South Korea, and Hong Kong may modestly reduce the U.S. trade deficits with these countries. However, the final impact on the overall U.S. trade deficit would probably be smaller than the reduction in these—bilateral trade deficits.

Third, more than just exchange rate changes are needed to reduce the U.S-Asian NIC trade imbalance. Further liberalization of restrictive trade barriers and macroeconomic changes that will increase domestic consumption in Korea and Taiwan—when combined with currency appreciation—would be effective in addressing the inherent bilateral trade imbalance problems. Because Hong Kong has an open economy, a mechanism for adjusting to international trade and payments imbalances, and only a small current account surplus, appreciation of the Hong Kong dollar is not essential.

Mr. Chairman, this concludes my statement. I will be happy to respond to any questions you or the members of the Subcommittee may have.

PREPARED STATEMENT OF SENATOR DANIEL PATRICK MOYNIHAN

Mr. Chairman, I want to commend you for holding this hearing and to express my dissatisfaction with the implementation of two sections of the Trade Act of 1988. Treasury is not vigorously pursuing an end to currency manipulation by our trading partners in Asia.

The Trade Act directed the Secretary of the Treasury to report to Congress on exchange rate policy. If our trading partners were found to be deliberately manipulating their exchange rates to gain an unfair trade advantage, the Secretary was directed to initiate negotiations in order to bring an end to exchange rate manipulation.

Nevertheless, it is widely known that the governments of Taiwan, Korea, Singapore and Hong Kong continue to deliberately set the value of their currencies in order to sharpen their ability to export to our market. In essence, the devaluation of these currencies acts as a subsidy to their export industries. The persistent high value of the dollar relative to these currencies acts as a tax on our export industries. As the value of the dollar has depreciated since September 1985 against the currencies of our major European trading partners and Japan—83 percent against the Yen—the governments of Taiwan and Korea have allowed their currencies to appreciate much less relative to the dollar: 49 percent and 34 percent, respectively.

The Treasury Department initiated bilateral negotiations to pressure Taiwan and Korea to end currency manipulation. However, the Treasury reported in April that these talks, which began only belatedly in October 1988, have not effected the desired change. Korea continues to manipulate the value of the won. Taiwan continues to manipulate the value of its dollar. Treasury has not been sufficiently vigorous in its negotiations to end currency manipulation.

Meanwhile, the problem of currency manipulation is surfacing with Thailand and Malaysia. The United States bilateral trade deficit with Malaysia increased by 33 percent in 1987 and 34 percent in 1988. Between 1985 and 1987 the Thai currency depreciated 7 percent against the dollar, and Thailand's bilateral trade surplus with the United States increased by 56 percent.

Taken together, Taiwan, Korea, Hong Kong and Singapore ran a trade surplus with the United States of $29 billion in 1988, 16 percent lower than 1987. However, the GAO recently reported that the final impact on the overall United States trade deficit will be minimal, because other nations will capture the share of the market lost by these Asian countries—namely Thailand and Malaysia. Worse still, the IMF predicted in April that the United States trade deficit is likely to worsen in 1989 and 1990. Clearly, action is necessary to prevent continued erosion of our current account position.

In addition to requiring exchange rate negotiations, the Congress included in the Trade Act of 1988 a section directing the Treasury and the United States Trade Representative to issue a report on trade projections by March 1 of each year. The purpose of this report is to identify developments in the international economy that should be factored into any formulation of United States trade policy. The gross miscalculations of the early 1980's, when Treasury Secretary Regan touted the strong dollar as evidence of a strong America, should not be repeated.

I am disturbed by the fact the the United States Trade Representative and Treasury have classified all of the projections in the report. The trade balance, economic growth rate, fiscal balances, and other projected economic variables for the United States and for our trading partners should not be secret. How is the Congress to challenge Administration policy—and the economic projections that follow therefrom—if we cannot discuss them in public? This is inconsistent with the intent of Congress and an effort to avoid public responsibility for what the world as the IMF has indicated—aleady knows: our trade deficit is getting worse.

I urge the Administration to implement these sections of the Trade Act in good faith. The Treasury must negotiate more vigorously to end currency manipulation by our trading partners. Projections of international economic factors must be made publicly available, to allow for more informed and effective debate on United States trade policy.

PREPARED STATEMENT OF DAVID C. MULFORD

Mr. Chairman and members of the Subcommittee: I welcome this opportunity to discuss the issues related to the exchange rate practices of Korea and Taiwan, particularly as the Treasury Department has recently released a report on international economic and exchange rate policy which addresses this matter.

For the last several years we have sought to reduce global trade imbalances in the context of a growing world economy. Our efforts to coordinate economic policies with other major industrial countries have focused on this goal. Indeed, last year economic growth in the G-7 exceeded expectations and there was a significant reduction in global current account imbalances. This strong performance provides a solid basis for continued progress in 1989, although there is some concern that external adjustment is slowing and that further efforts will be required.

We also recognize that others should play an integral role in preserving and ensuring a strong, stable world economy. In particular, the newly industrialized economies of Asia have benefitted from an open, growing international trading system. As such, it is essential for them to also work toward reducing global imbalances by allowing the value of their currencies to reflect the strength of their economies and by dismantling barriers to trade and investment.

To that end, we have held discussions with the Asian NIEs, beginning in mid-1986. The 1988 Trade Act provided impetus to this process by requiring the Secretary of the Treasury to issue periodic reports on international exchange rate policy and to determine which economies manipulated their exchange rates. In our first report, issued in October, we concluded that Korea and Taiwan were "manipulating" their exchange rates to gain a competitive advantage within the meaning of the legislation. Consequently, as required by the legislation, we have intensified our negotiations with Korea and Taiwan.

In reaching the conclusion, concerning manipulation of exchange rates, we looked at a wide range of factors to determine whether Korea and Taiwan were manipulating their exchange rates. An important factor was the existence in both cases of pervasive capital controls and administrative mechanisms aimed at preventing the exchange rate from reflecting market forces. A second factor was large-scale intervention in the local foreign exchange market by the Central Bank of Taiwan. A third factor was the lack of significant exchange rate appreciation at a time when Korea and Taiwan were running very large external surpluses in both absolute terms and relative to GNP. This relative lack of appreciation was particularly striking when compared with the appreciation of the currencies of other surplus economies.

Our negotiations with Korea and Taiwan have been aimed specifically at ending such currency manipulation. We have also sought other policy changes, including structural reforms to give greater emphasis to domestic demand as a source of growth and the liberalization of financial markets.

These negotiations have led to some encouraging progress. The currencies of both Korea and Taiwan have appreciated further. In addition, they have taken measures to open their markets and, to varying degrees, internationalize their financial systems. Indeed, we believe that due to these factors, a structural decline in their external surpluses may have begun. At the same time we believe that more progress is necessary.

KOREA

Appreciation of the Korean won accelerated in 1988, reaching nearly 16 percent, including about 4 percent in the 6 weeks following the release of our October report. Also, unlike in previous years, the won began to strengthen against the currencies of key competitors, such as Japan and Taiwan.

Although we welcome the appreciation of the won in 1988, its adequacy must be budged against its much slower appreciation in 1987 and the size of Korea's external surpluses. In 1988, Korea's global current account surplus grew 44 percent to $14.3 billion. To put this surplus in perspective, one need only realize that it was equal to 9.1 percent of Korea's GNP. In comparison, Japan's 1988 current account surplus was equal to 2.7 percent of its GNP.

The United States' bilateral trade deficit with Korea began in 1988 to show some limited prospects of improving, growing by only I percent, compared with a 34 percent increase in 1987. Encouragingly, this reflected stronger growth of our exports to Korea and decline in the rate of growth of our imports. Nonetheless, at $9.5 billion, our bilateral trade deficit remains unsustainably large.

Preliminary Korean data for the first quarter suggests a potentially significant decline in the trade and current account surpluses, due, in part, to the prior appreciation of the won. This data also indicate that Korea's bilateral surplus with the United States fell by 34 percent to $1.2 billion.

Unfortunately, the response of the Korean authorities to these welcome developments has been to reduce sharply the pace of the won's appreciation this year. Since the beginning of the year, the won has strengthened by only 2.7 percent against the dollar. Much of this occurred since late March, following another round of negotiations and the beginning of the preparation of our April report.

While we are somewhat encouraged by Korea's recent trade developments, we believe that the Korean current account data are too limited and preliminary to demonstrate clearly that a structural, lasting decline in Korea's external surpluses is underway. Indeed, we expect Korean exports to begin to recover in the second quarter, once the current labor disputes have been resolved. As such, further exchange rate appreciation is necessary to sustain and reinforce recent developments. However, due to concerns about the first quarter declines in the surpluses, the Korean authorities have not been willing to provide assurances of adequate continued won appreciation.

Our negotiations with Korea in the coming months will be aimed at obtaining assurances of continued appropriate appreciation. In addition, we will seek to engage the Korean authorities in a broad dialogue on their capital markets, including exchange controls and the banking and securities markets. We will also seek to obtain an understanding on the implementation of a market-based exchange rate system and the dismantling of the current system of comprehensive capital and exchange controls used to manipulate the exchange rate.

TAIWAN

A decline in Taiwan's external surpluses is also occurring. Taiwan's global current account surplus decreased by 43 percent in 1988 to $10.2 billion, or 8.5 percent of GNP. According to U.S. customs data, the trade imbalance with Taiwan, which accounts for 95 percent of its global trade surplus, fell last year by 26 percent to $12.7 billion. However, the large U.S. exports of gold to Taiwan accounted for more than half of this reduction. Preliminary Taiwanese data for the first four months of 1989, point to further reductions in Taiwan's trade surplus with the United States, compared to the same period in 1988, if last year's U.S. gold shipments are excluded.

The past appreciation of the New Taiwan (NT) dollar has been an important factor in the reduction of Taiwan's external surpluses. Furthermore, since our October report, the exchange rate has appreciated by 12 percent. Significantly, five percent of this movement has been since the release of our April report. We believe this exchange rate appreciation will reinforce the positive trends in Taiwan's external surpluses.

Taiwan also implemented a new exchange rate system in early April following a round of negotiations. Without this change, the recent currency appreciation would probably not have occurred. This new more market sensitive system could represent an important step toward the establishment of a market-based system to determine the exchange rate. However, it is premature at this point to make a definitive assessment of its impact. The effectiveness of the liberalization will depend on reducing the extent of central bank intervention, removing the remaining controls on capital inflows, and resolving a number of operational problems with the system itself. Consequently, we will monitor carefully its implementation and operation.

Given the recent sharp appreciation of the New Taiwan dollar, the reduction in external surpluses, and the institution of the new exchange rate system, there may not be a need for further appreciation at this time. We will, however, continue to monitor Taiwan's exchange rate and trade developments closely to ensure that momentum toward external adjustment is sustained.

CONCLUSION

In conclusion, Mr. Chairman, we believe that Korea and Taiwan have an important role to play in reducing external imbalances. The progress we have achieved in our bilateral negotiations with Korea and Taiwan could lead to a sustainable decline in their external imbalances. In the period before our next report in October, we will aim to have these economies continue to correct their policies to avoid an unfair competitive advantage in trade and, hence, contribute to the global adjustment process.

Enclosure.

Responses to Questions Submitted by Senator Moynihan

Question. In addition to Korea and Taiwan, what other countries have been approached by Treasury to discuss their exchange rate policies on a bilateral basis?

Answer. Treasury has discussed exchange rate policies with officials from Hong Kong and Singapore, in addition to Korea and Taiwan. As both have virtually no controls on capital flows and on merchandise imports and given the more modest size of their current account surpluses, we concluded that they were not "manipulating" their currencies (within the meaning of the legislation) in a manner that impeded adjustment of global imbalances. Hence, we did not initiate formal negotiations with them.

Question. Specifically, has Treasury had exchange rate policy discussions with the following countries: Hong Kong, Singapore, Thailand and Malaysia? If not, why not?

Answer. Treasury has not entered into exchange rate policy discussions with Thailand and Malaysia, because we believe that at the present time their exchange rates reflect their economic fundamentals. However, Treasury continues to monitor their policies.

In the case of Malaysia, despite depreciation of the ringgit in 1988, the current account surplus fell to $1.9 billion from $2.5 billion in 1987. For its part, Thailand's growing current account and global trade deficits—$1.8 billion and $3.8 billion respectively in 1988—and relatively low GDP per capita income (around $900) are evidence that Thailand is not "manipulating" its exchange rate for competitive gain within the meaning of the legislation.

Question. On what basis did Treasury classify all of the projections in the Annual Trade Projection Report established by the 1988 Omnibus Trade Act and submitted on March 1, 1989? Specifically, explain why if data is already projected by OMB and CBO on an unclassified basis, including interest rates, fiscal balances, and growth rates, this same data can be legitimately classified in the annual trade projection report? Will Treasury consider submitting a revised report lifting the confidential designation? If not, why not?

Answer. Some of the projections in the *Annual Trade Projection Report* were classified (i.e., most of those that appear in the Statistical Appendix), but the projections in the *Report* itself were not. Classification applies specifically in Appendix Tables 1-3 to forecasts for specific foreign industrial countries, LDCs, and OPEC, and to the projections for the U.S. trade and current account balances for 1989-90. (The historical data, U.S. GNP growth projections, and the aggregate projections (e.g. for the OECD as a group) are not classified.)

The bases for this selective classification are the desire (1) to avoid publicizing projections for other countries that could be inconsistent with foreign official forecasts and thereby to avoid irritating our allies and making the atmosphere for international cooperation more difficult· and (2) to avoid presenting preliminary Treasury staff projections for the U.S. balance of payments as official forecasts.

The reasons for the classification of these projections in the Appendix still apply. Thus, it is not possible to declassify this material.

Prepared Statement of John Williamson

INTRODUCTION

The East Asian new industrial economies (NIEs) provide the best possible advertisement for the economic policies that the United States has long urged other countries to pursue. By adopting a capitalist system, encouraging the growth of exports, and pursuing prudent macroeconomic policies, they have in a few short generations transformed themselves from basket cases to nascent industrial powers. (And they have accomplished that with some of the poorest resource bases in the world.) It is crucial that, in its quite proper urge to ensure that other countries adopt policies consistent with a correction of the US balance of payments deficit, the United States not jeopardize the impressive success that these countries have achieved.

CRITERIA FOR JUDGING EXCHANGE RATE POLICY

None of the three East Asian currencies being analyzed in these Hearings floats, in the sense that its value is determined by the interaction of private demand and supply in the foreign exchange market. The Hong Kong dollar is linked to the US dollar, in an arrangement which approximates the classical gold standard. Both Korea and Taiwan manage their currencies actively, using discretionary policy to determine their exchange rates.

The mere fact that currencies are managed rather than allowed to float should not be taken as evidence of "manipulation" in the sense of the Omnibus Trade Act, which clearly intended to pinpoint currencies suffering from undervaluations maintained deliberately despite the costs imposed on other countries. Floating is not a guarantee that a currency is properly aligned: both the dollar and the pound sterling suffered undervaluations and even more extreme overvaluations during periods when they were floating freely. Neither is pegging or active management a synonym for misalignment: many currencies remained pegged near equilibrium levels for years on end under the Bretton Woods system. If one equated "manipulation" with not allowing market forces to determine the exchange rate, it is not obvious that the management of their currencies by the Group of 7 on the basis of secret reference ranges should escape censure.

Thus the relevant question is not whether the East Asian currencies float but whether they are undervalued. A currency is undervalued when it is so cheap that even with the domestic economy operating at full capacity the country in question would generate an excessively large current account surplus in the medium run.

Note that the relevant criterion is the country's *multilateral* balance, and not its bilateral balance with a particular trading partner. Bilaterally unbalanced trade is an inherent feature of an efficient international division of labor in a multicountry world. The need of the East Asian NIEs to import large volumes of fuel and raw materials requires them to run bilateral surpluses with the United States even when they are in multilateral balance, as the simulations of a model constructed by my colleague William Cline, shown in the first 3 rows of table I, demonstrate. To deny them the opportunity of efficient triangular trade and seek to impose bilateral trade balance on them would be to emulate one of the most oppressive features of Soviet policy toward its East European allies during the Brezhnev years.

A much more difficult question in interpreting the concept of undervaluation is to say when a current account surplus is "excessively large." My own view is that one should approach this task by making estimates (which will doubtless be crude) of the global size of desirable deficits. "Desirable" deficits are those that satisfy two criteria: they would result in a flow of real resources to areas with productive investment opportunities in excess of local savings, and they could be financed safely on a sustainable basis. The global sum of such desirable deficits might then be shared around pro rata with GNP among those countries where desired local savings exceed investment opportunities. I have tried to do an exercise of this type, and provisionally conclude that the internationally consistent annual surpluses of Korea and Taiwan might be around $1.5 billion each. Thus, even if one accepts that it is in the national interest of Korea and Taiwan to run surpluses (which I actually think is doubtful), the scale of surpluses seen recently- over $10 billion a year each—is far too large.

SIMULATIONS OF CURRENCY APPRECIATION

Before proceeding to apply the above criteria in evaluating the current policies of Hong Kong, Korea and Taiwan, it may be useful to record the results of some simulations of appreciations of their currencies run at the Institute for International Economics. The simulations were undertaken on the EAG (economic adjustment with growth) model constructed by my colleague William Cline[1]. This is a model that distinguishes 17 trading blocs, one of which is Taiwan and another of which is Korea, Singapore and Hong Kong together. Although the inclusion of Singapore is undesirable in this context, it is by far the smallest of the three economies and hence unlikely to distort the results significantly.

The baseline simulations of 1992 trade flows shown in the first 3 rows of table I assumed that real exchange rates would remain constant at the levels reached in the final quarter of 1987 and that output growth would average 2.6 percent per year in the United States and 8 percent in Taiwan and Korea-Singapore-Hong Kong. With these assumptions the United States current account deficit is predicted to widen to $168 billion by 1992, even though both groups of Asian countries are predicted to move into modest current account deficit. (The final three columns show bilateral trade with the United States: as mentioned above, they show big US bilateral deficits with the East Asian NIEs even when their overall trade is in modest deficit.) Unfortunately this prediction of elimination of the surpluses of the East Asian NIEs by 1992 even on the basis of end-1987 exchange rates is among the least

[1] William R. Cline, *American Trade Adjustment: The Global Impact*, Institute for International Economics, Washington, 1989.

reliable of Cline's results, since it depends heavily on an assumption that their exports will be less responsive to foreign income growth than in the past.[2]

Nonetheless, the model can be used to calculate the *changes* in trade flows that would be expected to result from exchange-rate changes. The second three rows of the table assumed a simultaneous 10 percent real appreciation of the four East Asian currencies. Since real growth rates were assumed to remain unaffected by these appreciations, there is an implicit additional assumption that the Asian NIEs would accompany their currency appreciations by expansionary demand management policies designed to replace the fall in external demand by increased internal demand (as Taiwan in fact did in 1988).

The final three rows of the table show the net effect of appreciation accompanied by expansionary demand policies that neutralize the output effect of the fall in external demand. The simulations suggest that these policy changes would increase the East Asian trade deficit by $39 billion and the current account deficit by $47 billion, of which $15 billion and $19 billion respectively would serve to reduce the US trade and current account deficits. The bilateral US trade deficit would decline by $16 billion.

These figures are much larger than the $3.5 billion reduction in the bilateral US trade deficit and $9.6 billion reduction in the East Asian trade surplus found in the GAO/DRI study. One would expect a substantially larger result in the EAG simulations, for three reasons: they assumed a 10 percent *real* rather than *nominal* appreciation; they assumed that appreciation was accompanied by expansionary measures that would prevent a decline in output; and they include Singapore. Those three factors together might be expected to double the impact of an appreciation; thus there remains reason for suspecting that the GAO/DRI results may be on the low side.

POLICY EVALUATION

The study by Bela Balassa and myself[3] concluded that the Hong Kong dollar, the Korean won and the New Taiwan dollar were all significantly undervalued in April 1987. We argued that all three countries had erred in the preceding two years in pegging their currencies closely to the dollar, thus achieving a further gain in competitiveness that was likely to lead Korea to follow Taiwan in generating an excessively large surplus that would be both unwelcome to its trading partners and a poor use of its own resources. Hong Kong might be expected to allow its surplus to expand the money supply rapidly, thus adjusting the old-fashioned (gold standard) way, through inflation. Korea and Taiwan might follow suit, eventually. But we argued that all three countries would be well-advised to preempt the process of adjustment through inflation by a prompt currency appreciation accompanied by demand expansion and the dismantling of import controls (except in Hong Kong, where these were already nonexistent). We did not recommend that Korea and Taiwan should dismantle their exchange controls, because of the danger that capital inflows would force excessive appreciations that would jeopardize their continued growth.

None of the three countries welcomed our advice. However, while Hong Kong has remained steadfast in its opposition to the present day, both Korea and Taiwan have made substantial policy adjustments. I shall proceed to evaluate the situation in each country.

Hong Kong has maintained its exchange rate against the dollar unchanged, and had no trade (or exchange) controls to dismantle. As a result of the depreciation of the US dollar after 1985, the real effective exchange rate of the Hong Kong dollar depreciated almost 20 percent (table 2, row 2). This appears to have induced a sizable current account surplus (though one cannot be certain, since Hong Kong does not collect or publish statistics of the current account). The resulting inflow of funds added automatically to the money supply and this has generated a significant inflation: wages rose about 20 percent last year, consumer prices rose over 10 percent in the 12 months to February, and the real effective exchange rate appreciated 15 percent between the end of 1987 and March 1989. Adjustment is occurring automatically, as one expects it to in a laissez-faire economy that follows the rules of the gold standard.

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[2] This assumption was made for technical reasons. To reduce the sensitivity of the results to erratic estimates of income elasticities of export demand, Cline averaged the estimated country elasticity with the average elasticity for all countries. In most cases it could be argued this would make the results more reliable, but he conceded that this might well not be true for the East Asian NIEs.

[3] Bela Balassa and John Williamson, *Adjusting to Success: Balance of Payments Policy in the East Asian NICs*, Institute for International Economics, Washington, 1987.

The fact that adjustment is occurring does not mean that Hong Kong should be applauded on its policy choices. Inflation is no less undesirable when it results from the automatic rules of the gold standard than when it results from governments lacking the courage to raise enough taxes to cover their expenditures. Hence I continue to believe that the Hong Kong authorities did their citizens a grave disservice in not shifting to a basket peg in 1986, which would have avoided the perverse depreciation of 1987 and hence limited the inflationary pressures to which Hong Kong is now subject.

Moreover, the adjustment process is not yet complete. Balassa and I estimated that a real effective appreciation of around 10 percent to 15 percent was called for as of April 1987, whereas the net appreciation that has so far been realized amounts to scarcely one-half of that. However, I have little doubt that the remainder of the adjustment will occur in due course under present arrangements—unless, at least, Hong Kong citizens choose to place large sums of money abroad in anticipation of the Chinese takeover in 1997 (in which case the automatic monetary adjustment mechanism would be ruptured) In neither event can I see that the United States or the other industrial countries have any significant self-interest in persuading Hong Kong to modify its current policies.

Korea has undertaken substantial import liberalization in the last two years. It has also appreciated the won 29 percent against the dollar, leading to a real effective appreciation of 19 percent, between the end of 1986 and Spring 1989. These actions were too delayed to prevent an inflationary boom developing, with wage increases of 20 percent or more last year, real GDP growing at around 12 percent, and consumer prices rising by some 7 percent.

The current account surplus was over $14 billion in 1988. However, under the reinforcing impacts of rapid growth in domestic demand, import liberalization, and real appreciation resulting from both nominal appreciation and domestic inflation, the surplus has been sharply lower in recent months. Moreover, Korea has now secured a real appreciation of more than the 10 percent to 15 percent from April 1987 levels that Balassa and I judged to be called for. Similarly, Cline's desirable adjustment package calls for an exchange rate of 680 won to the dollar, which has already been surpassed.

These comparisons do not provide grounds to be sure that Korea has already done enough to secure adjustment. (For example, Cline recognizes that his procedures probably result in an underestimation of the export growth of both Korea and Taiwan.) Nevertheless, they do suggest that it would be wrong to fail to recognize the important progress that Korea has already made. Countries like Korea need a trend appreciation in their real exchange rates in order to avoid the exceptionally rapid productivity increases in their tradable goods sector leading to a secular increase in their current account surplus, but I see no clear evidence that the won is currently undervalued.

Taiwan was the first of the three countries to start appreciating its exchange rate, back in mid-1986. It has secured the largest bilateral appreciation against the dollar since 1981, 1985 or 1986, and is the only one of the three countries to have a stronger real effective exchange rate than in 1981 (table 2). It has also undertaken substantial import liberalization (although, as in Korea, the process is not yet complete) The relatively prompt policy response may help to explain why, although Taiwanese domestic demand is also booming now, inflation is less virulent than in Hong Kong or Korea.

The earlier initiation of adjustment also explains why the Taiwanese current account surplus actually fell between 1987 and 1988, from $18 billion to $10 billion. It is true that a part of this decline is a statistical artifact reflecting a decision to import gold and classify it as a commodity rather than a monetary asset, but even after allowing for that there is no doubt that the trend is in the right direction. The question is whether enough has yet been achieved. Balassa and I estimated that an appreciation of 15 percent to 25 percent from the April 1987 level was called for; some 17 percent had already occurred as of March, and the NT dollar has appreciated a further 7 percent against the dollar since then. Similarly, Cline's preferred adjustment package posited a rate of about NT$25 = US$1, as against a present rate that is just under NT$26. On the basis of these figures it seems that Taiwan may be reaching the point at which it would be reasonable to decelerate the real appreciation of the NT dollar to its trend rate (perhaps 3 or 4 percent a year). It is true that the current account surplus remains enormous relative to the size of the economy, but it is important to recognize that trade flows respond to exchange rate changes only with a long lag. Once again, I see no clear evidence that the NT dollar remains overvalued.

While it is appropriate to urge Taiwan to continue appreciating at the trend rate and to complete the process of import liberalization, one should recognize that the adjustment process would be much further advanced if the United States had already acted as decisively as Taiwan. The continuing trade deficit is a consequence of the failure to correct fiscal policy, not of actions by the East Asia NIEs.

Enclosure.

TABLE 1.—EFFECTS ON 1992 TRADE AND CURRENT ACCOUNT BALANCES OF 10 PERCENT REAL APPRECIATION BY TAIWAN AND KOREA-SINGAPORE-HONG KONG

[In billions of dollars]

	Total exports	Total imports	Trade balance	Current account balance	Trade with U.S. Exports	Trade with U.S. Imports	Trade with U.S. Balance
Baseline:							
United States	501	625	−124	−168	na	na	na
Taiwan	78	76	1	−2	29	19	10
Korea-Singapore-Hong Kong	236	247	−11	−7	68	40	28
With appreciation:							
United States	506	615	−109	−149	na	na	na
Taiwan	72	80	−8	−13	26	21	5
Korea-Singapore-Hong Kong	217	258	−41	−43	59	42	17
Effect of appreciation:							
United States	+5	−10	+15	+19	na	na	na
Taiwan	−6	+4	−9	−11	−3	+2	−5
Korea-Singapore-Hong Kong	−19	+11	−30	−36	−9	+2	−11

Source: EAG Model (see William R Cline, ***American Trade Adjustment: The Global Impact,*** Institute for International Economics, Washington, 1989.)

na - not applicable.

TABLE 2.—EXCHANGE RATES OF EAST ASIAN NIEs (END-1986 = 100)

	1981	1985	End-1986	April 1987	End-1987	Spring 1989 [1]
Hong Kong:						
Bilateral dollar exchange rate	137	100	100	100	100	100
Real effective exchange rate	104	109	100	97	91	103
Korea:						
Bilateral dollar exchange rate	126	99	100	102	109	129
Real effective exchange rate	132	118	100	99	97	119
Taiwan:						
Bilateral dollar exchange rate	96	89	100	105	124	137
Real effective exchange rate	113	105	100	110	107	117

[1] Bilateral dollar exchange rates as of May 9 Real effective exchange rates as of March.

Sources: ***International Financial Statistics,*** Morgan Guaranty ***World Financial Markets,*** and ***Financial Statistics*** of the Central Bank of China (Taiwan).

COMMUNICATIONS

STATEMENT OF THE AMERICAN IRON AND STEEL INSTITUTE, CONCERNING CURRENCY MANIPULATION BY KOREA

The American Iron and Steel Institute ("AISI") strongly supports the statement by Senator John Heinz during the Committee's May 12 hearing that South Korea's artificial manipulation of its currency has, in regard to steel and other products exported to the U.S., the same effect as dumping in the U.S. market and that it, moreover, effectively provides a subsidy which should be countervailable under U.S. law. AISI also supports Senator Heinz's suggestion that currency manipulation and the unfair trade advantages it permits should be addressed in the ongoing Uruguay Round in the GATT. AISI believes that Korea's manipulation of its currency, which has been examined and deemed "unfair" by the U.S. Treasury Department, demonstrates beyond question that the Koreans are not, as they claim, "fair traders" when it comes to steel exports to the U.S. and thus entitled to exemption under any renewal of the Voluntary Restraint Arrangements.

The standard definition of dumping is price discrimination. Dumping is usually measured by comparing a company's prices of goods sold in the U.S. with prices of goods sold in the home market. Because the prices in the two markets originally are in different currencies, the pricing comparison is sensitive to changes in exchange rates. An undervalued home market currency is one way to minimize exposure to dumping charges, since it mean that fewer dollars will equate to the same amount of home currency. Thus, instead of the U.S. can simply rely on an undervalued local currency to keep prices in the U.S. (in dollar terms) artificially low.

In addition, from an economic standpoint, it is clear that the deliberate undervaluation of the home currency bestows a benefit upon exporters which constitutes a subsidy. Since the same amount of dollars translates into a greater amount of local currency than otherwise would be the case, exporters can benefit either by earning larger unit profits on export sales, or by lowering U.S. price to gain market share. Moreover, Korea's undervalued currency is the result of government actions which benefit primarily exporters. Korean companies that export find that they can maintain or lower U.S. prices, gain market share, and not suffer any loss of revenues as a result of currency manipulation. Producers that do not export, however, are adversely affected, because they are required to pay higher prices for imports as a result of the undervalued home currency. Currency manipulation thus constitutes a de facto export subsidy. The administration should therefore aggressively seek to categorize currency manipulation as an export subsidy in the ongoing Uruguay Round negotiations, and, in the meantime, should take steps under existing U.S. trade law to address this issue.

STATEMENT OF ANN OTTOSON KING, LEIGHTON & REGNERY

I. INTRODUCTION

This written testimony is submitted in response to Press Release #H-20, dated April 19, 1989 announcing a hearing on Currency Manipulation and requesting written comments be submitted by May 26, 1989. The theme of this presentation is to demonstrate that currency manipulation, especially in the form of multiple exchange rates (MER's), can be considered an unfair trade practice in the generally accepted sense and to point out the interrelationship between the General Agreement on Tariffs and Trade (GATT) and the Articles of Agreement of the International Monetary Fund (IMF).

II. MULTIPLE EXCHANGE RATES

Multiple Exchange Rates (MER's) exist when there is more than one rate at which a nation's currency can be converted into another currency (or special unit[1]). The MER's which are here considered are sanctioned, imposed and monitored or enforced by the government of the country in which they are imposed.[2] An example of a MER's is when a country maintains a "official exchange rate" at which other currencies must be traded within its geographical boundaries by individuals while the government trades the other currencies (outside its boundaries) at a different rate. Actual practices may not be this direct and may involve several different rates (e.g. one for importing needed goods, one for importing luxury goods, and one for buying imported luxury goods in a government-operated store, etc.).

From outside the country in which they operate, MER's are often viewed in a negative light. From inside the country they may be seen as a way to regulate a severe balance of payments problem or an attractive way of obtaining amounts of hard currencies with which to purchase needed or desired imports. Used to adjust balance of payments problems, MER's are sometimes sanctioned by the IMF; used to collect hard currency, MER's are looked on much less favorably.

III. THE INTERRELATIONSHIP OF GATT AND THE IMF

The most obvious place where the GATT and the IMF are inter-related in this context is in ARTICLE XVI (Subsidies) of the GATT.[3] This article requires any contracting party who grants or maintains any subsidy which directly or indirectly benefits exports to notify the other contracting parties of this grant or subsidy. The granting of such subsidy may hinder the achievement of the objectives of the Agreement. A note to Article XVI, however, states:

> Nothing in Section B shall preclude the use by contracting party of multiple rates of exchange in accordance with the Articles of Agreement of the International Monetary Fund.[4]

A further note exempts a system for stabilization of domestic prices so long as exports are not stimulated unduly,[5] and not government funded. According to one commentator,[6] a 1955 working party report [7] noted the subsidy provisions which were added to the GATT were considered assuming that the following section of the GATT would not be altered:

> 9. Nothing in this Agreement will preclude:
>
> (a) the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund or with that contracting party's special exchange agreement with the Contracting Parties.[8]

But the 1960 working party felt there was an obligation to notify the contracting parties of multiple exchange rates which have the effect of a subsidy.[9] Article XV, with which this discussion deals is the section regarding Exchange Arrangements.

Article VIII (Fees and Formalities connected with Importation and Exportation) directs that these fees shall be related directly to the costs involved and not act as barriers to trade.[10] Note I clarifies the relation of this article to MER's and the IMF:

> 1. While Article VIII does not cover the use of multiple rates of exchanges as such, paragraphs 1 and 4 condemn the use of exchange taxes or fees as a device for implementing multiple currency practices; if, however, a contracting party

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[1] Such units might include European Community Units (ECU's) or International Monetary Fund Special Drawing Rights (SDR's) or any other substitute for money which can be freely traded and has an ascertainable, published value in different currencies but is not a currency.

[2] Thus, special exchange rates for money-laundering or black-marketing, etc. are excluded.

[3] General Agreement on Tariffs and Trade, Basic Instruments and Selected Documents (B.I.S.D.) Volume LV, Text of the General Agreement, 1969, Geneva, 1969, p. 26.

[4] Ibid., Ad Article XVI, Section B, p. 68.

[5] Ibid., Note 2 to Paragraph 3. NOTE: To fulfill these requirements there must be a determination by the contracting parties that the system resulted in or was designed to result is a higher price being charged to foreign than to domestic buyers and is so regulated that its operation whether through regulation of production or otherwise does not unduly increase exports so much as to seriously prejudice the interests of other contracting parties.

[6] See Jackson, John H., *World Trade and the Law of GATT*, Indianapolis: The Bobbs-Merrill Company, Inc., 1969, p. 386.

[7] GATT B.I.S.D., 3d Supp., 1955, p. 226.

[8] GATT B.I.S.D., Vol. IV (cited note 22 supra.) p. 26.

[9] GATT B.I.S.D., 9th Supp., 1961, p. 192.

[10] GATT B.I.S.D., Vol. IV (cited note 22 supra.) p. 14.

> is using multiple currency exchange fees for balance of payments reasons with the approval of the International Monetary fund, the provisions of paragraph 9(a) of Article XV fully safeguard its position.[11]

According to one commentator, "Shall" was inserted into Paragraph 1 in place of "Should" in 1955 working party discussions [12] to ensure that the provisions were obligatory.[13] The GATT basically rejects the use of MER's unless they are used to right balance of payment problems with the blessing of the IMF.

The IMF, for its part, has restrictions on MER's, most specifically under Avoidance of Discriminatory Currency Practices.[14] This section clearly states "No member shall engage in . . . any discriminatory currency arrangements or multiple currency practices . . . except as authorized under this Agreement or approved by the Fund . . ." Such practices as were in place at the time of becoming a member were "grandfathered" to allow them to be phased out. "In particular, members shall withdraw restrictions maintained under this section as soon as they are satisfied that they will be able, in the absence of such restrictions, to settle their balance of payments in a manner which will not unduly encumber their access to the general resources of the Fund." [15] Any sanction for non-abandonment is, however, administrative.[16]

IV. POTENTIAL FOR UNFAIR TRADE PRACTICE CASES

The U.S. businessman or organization who wants to bring an action against a foreign country's exports involving an MER potentially may seek four types of actions: antidumping (AD), countervailing duty (CVD), unfair government action (301) and unfair trade practice (33).

The GATT provides:

> Multiple currency practices can in certain circumstances constitute a subsidy to exports which may be met by countervailing duties under paragraph 3 or can constitute a form of dumping by means of a partial depreciation of a country's currency which may be met by action under paragraph 2. By "multiple currency practices" is meant practices by governments or sanctioned by governments.[17]

This note, the basic U.S. statutes and Article VI of the GATT all cover both AD and CVD jointly. This note makes clear such practices are likely violations of AD and CVD provisions of the GATT. As the U.S. law incorporates the terms of the GATT, they should also be violations under U.S. law. Since CVD cases are directed at subsidies, and a dual exchange rate which lowers the cost of components or encourages exports for hard currencies is a subsidy under the GATT, a CVD is clearer. One must ascertain whether the MER was set up with the sanction of the IMF, however, as such a system would be exempt.

Unless sanctioned by the IMF, a MER would seem to be an unfair government action and not being in agreement with a signed trade agreement sufficient for a 301 investigation. Clearly the basic burden of proof would be met—there is an agreement which prohibits it (the GATT) and the country in question is violating it. If injury to the domestic industry because of this action can be shown, there is an added advantage and negotiations could result.

Having a MER declared an unfair trade practice under 19 U.S.C. § 1337 would take work. The statutory basis is clearly broad enough, but there is no precedent.

IV. CONCLUSION

In summary, there are four separate trade actions under U.S. law which can find unfair trade practices to exist. With the exceptions noted above, there could be grounds for finding a MER is an unfair trade practice under any one of the four actions, unless sanctioned by the IMF to assist a country in dealing with a balance of payment problem over the short run. This Committee should make its position on currency manipulations clear to those changed with enforcing our trade laws.

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[11] Ibid., p. 65.

[12] GATT B.I.S.D., 3d Supp., 1955, p. 214-5.

[13] Jackson, op. cit., p. 455.

[14] Articles of Agreement of the International Monetary Fund, Washington D.C.; The International Monetary Fund, (Reprinted) May 1982, Article VIII, General Obligations of Members, Section 3, p. 29.

[15] Articles of Agreement, supra., Article XIV, Section 2, p. 49.

[16] Ibid., Section 3.

[17] GATT B.I.S.D. Vol IV, Ad Article VI, Paragraphs 2 and 3, p. 64.

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