United States General Accounting Office 138600

GAO

Testimony

138600

For release on Delivery Expected at 10:00 a.m. EDT Friday May 12, 1989

U.S. TRADE DEFICIT: Impact of Currency Appreciations in Taiwan, South Korea, and Hong Kong

Statement of
Allan I. Mendelowitz, Director
Trade, Energy, and Finance Issues
National Security and International Affairs Division

Before the
Subcommittee on International Trade
Committee on Finance
United States Senate

045378/138600

GAO/T-NSIAD-89-28

GAO Form 160 (12/87)

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.[1]

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

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

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 $45 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 $35.4 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.