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**And Now Won/Dollar Negotiations?
Lessons From the Yen/Dollar Agreement of 1984**

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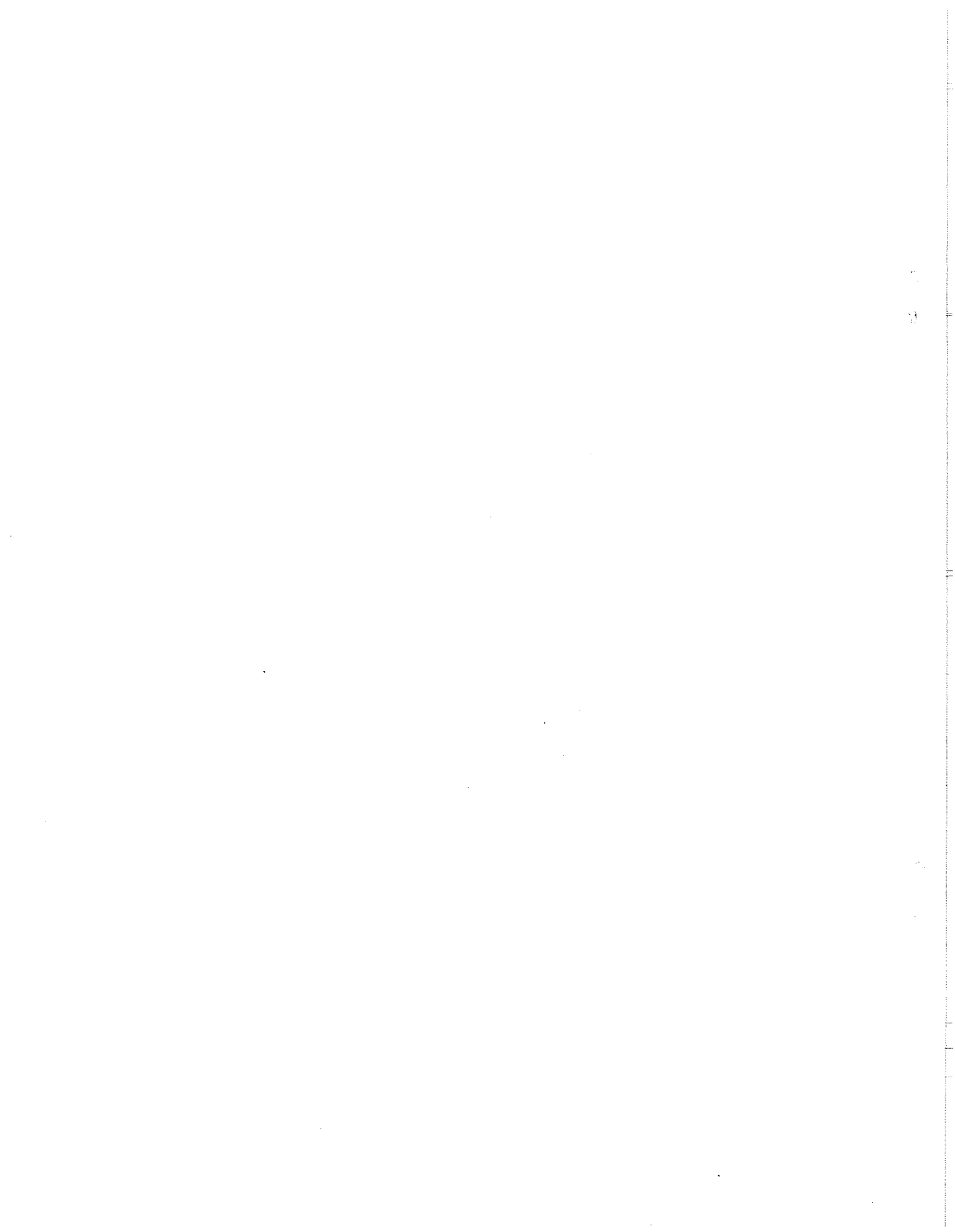
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Abstract

In 1984, a U.S. Treasury campaign for the liberalization of Japanese financial markets came to fruition in the form of the Yen/Dollar Agreement with Japan's Ministry of Finance. In 1990 the Treasury is launching "Won/Dollar talks," with the aim of bringing about the liberalization of Korean financial markets and the appreciation of the won. This paper reviews the political origins and economic effects of the yen/dollar campaign, and attempts to draw lessons for the current episode. The conclusion is that, while liberalization in Asian countries is a good thing overall, it may be a mistake to identify such liberalization with appreciation of the Asian currencies against the dollar and with the economic interests of the United States. Furthermore, there is nothing in free-market principles that says that Korea should refrain from intervening in its foreign exchange market.

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And Now Won/Dollar Negotiations?
Lessons from the Yen/Dollar Agreement of 1984

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This paper was written for a meeting at the Institute for International Economics, Washington, D.C., held jointly with the Korean Development Institute, December 12, 1989.

The last ten years have seen rapid structural change in Japanese financial markets, a trend accelerated by U.S. pressure. This pressure came particularly in the form of a campaign by the U.S. Treasury, with appreciation of the yen as its major goal, that culminated in the May 1984 Yen/Dollar Agreement with the Ministry of Finance. The structural change has consisted of both international and domestic liberalization. Its consequences have included an accelerated flow of capital from Japan to the United States [working to narrow the differential between U.S. and Japanese rates of return and to integrate the international financial system], a more flexible, integrated and market-oriented financial system within Japan, and somewhat greater ease of operations of foreign providers of financial services.

The foregoing characterization of recent Japanese financial liberalization is not without controversy. Its constituent propositions

have had detractors who would argue differently. This paper begins by considering their arguments, and responding. It also evaluates the desirability, under a variety of possible economic and political criteria, of the Yen/Dollar Agreement in retrospect, and of a Won/Dollar Agreement in prospect. A theme of the paper is that the beneficial implications of Asian liberalization for U.S. "competitiveness" are much less clear than one would infer from observing the amount of U.S. pressure applied.

The paper concludes with the view that it may be misguided for Americans to appeal to free-market principles to justify pressure on Asian countries to allow their currencies to appreciate against the dollar. In the case of the Korean won, the reason is that, although it is true that an end to foreign exchange intervention would result in appreciation against the dollar, it is perfectly appropriate for a small country to seek exchange rate stability if it so desires. American negotiators would perhaps be better advised to concentrate on negotiating the liberalization of trade in goods and services, where the appeal to principle is on secure ground.

1. The Extent of Japanese Liberalization

It might seem unnecessary to document the magnitude of the changes associated with the Yen/Dollar Agreement, and with Japanese liberalization more generally. But it is worth recalling that the American public reaction in May 1984 was the common one, "Ho hum. We all know nothing ever changes in Japan." A sample evaluation was offered by Lester Thurow, under the headline Yanks Hoodwinked Again: "The Reagan Administration spent almost four years yelling during

negotiations but, at the end, got a miniscule change in the Japanese financial system...Once again Americans have been out-negotiated by the Japanese."¹

The specific measures enacted at the time of the May 1984 Agreement, to internationalize the yen and liberalize Japanese financial markets both domestically and internationally, have been described elsewhere. Some of the measures foreseen in the Agreement that have been enacted since then include: establishment of new short-term financial markets (in yen-denominated banker's acceptances, June 1985, short-term bonds, November 1986, and commercial paper, November 1987), further liberalization regarding the Euromarket (such as allowing foreign companies to lead-manage Eurobond issues in December 1986, and introducing rating systems for Eurobonds in 1987), establishment of an offshore market in Japan (December 1986), the admission of major American securities companies to the Tokyo Stock Exchange (approximately 22 by the end of 1987), and inclusion of foreign firms in the syndicate through which the Japanese government sells its bonds and in the trust business (9 banks authorized after October 1985).² In addition, the Ministry of Finance liberalized restrictions on what share of their portfolios Japanese insurance companies and trust banks could hold in the form of foreign securities (in 1986 and 1987). Although the usual view is that domestic liberalization has lagged behind international liberalization -- some small investors, for example, still not having access to fully market-determined interest rates on their deposits -- at the corporate level

¹ Boston Globe, June 5, 1984, p.28. Other press reactions are cited in Frankel (1984, p.53).

² Ido (1989).

there is evidence that the traditional ("main-bank") relationships have been breaking down, and that the system is becoming more market-oriented.³ Thus the answer to the question, "Has the proclaimed liberalization of Japanese financial markets in fact been substantive?," is "yes."

Some statistics illustrate the extent of the change. The net rate of long-term capital outflow from Japan increased from \$ 17.7 billion in 1983 to \$49.6 billion in 1984 and 137.1 billion in 1987. The increases in gross quantities are even greater. The Euroyen bond market increased from \$1.7 billion outstanding in 1983, to \$ 61.9 billion in 1987. The total yen bond market in Japan and worldwide increased from \$755.7 billion in 1983 to \$2033.0 billion in 1987 (ranking second after the share of the U.S. dollar at \$3717 billion). Completing the usual litany of new-found Japanese financial importance: the total capitalization of the Japanese stock markets (as conventionally measured) has passed that of U.S. stock markets, the size of the foreign exchange market in Tokyo has probably passed that of New York, and Japanese banks have taken over the majority of the top 30 positions in international rankings.

2. The Original U.S. Treasury Motive Behind the Yen/Dollar Campaign

The next question is whether the liberalization process was accelerated by a deliberate campaign on the part of the U.S. Treasury, or whether it would have happened anyway. It is clear that there already existed in Japan

³ Frankel (1989) describes the evidence and gives further references.

powerful forces at work in favor of liberalization.⁴ But the fact that a minority of political actors seize upon *gaiatsu* (foreign pressure) to further their own goals does not negate the fact that such pressure is a factor that results in an acceleration of the process to a degree that would not happen in its absence.

While the magnitude of the changes that came out of the negotiations has become less and less subject to debate over the last five years, the original motivations of the Reagan Administration have become more muddled. A number of different motives have been attributed to Treasury policymakers.⁵

The argument that superficially might seem the most reasonable is that they recognized, in the face of a large and rising federal budget deficit and a small and shrinking personal saving rate, that the country was becoming increasingly dependent on borrowing from abroad, and that it was desirable to facilitate that inflow in order to prevent interest rates from rising and crowding out private investment. This analysis of the politics, which is made by Destler and Henning (1989, p. 28-29), seems reasonable because the United States was indeed becoming increasingly dependent on foreign capital, as rising interest rate differentials reflected, and the subsequent removal of Japanese capital controls did in fact turn out to have

⁴ Japanese banks, for example, had been agitating for deregulation of interest rates since the mid-1970s, as the obligation to buy government bonds at artificially low interest rates became ever more onerous. [They may also have foreseen that they had more to gain from no-holds-barred international competition than to lose.]

⁵ It is hopeless to look to the White House for a motive, assuming one seeks a rationale at a level more realistic than the usual poetic anthropomorphization of an entire Administration. The Yen/Dollar Agreement was entirely a Treasury operation.

the effect of accelerating the capital outflow.⁶

Nevertheless, the motive of facilitating U.S. borrowing did not in fact enter Treasury thinking at the time of the Yen/Dollar Agreement. What Destler and Henning have in mind is the measures taken by Treasury policy-makers subsequently, as they were increasingly forced to reckon with the new dependence on capital inflows, beginning in the summer of 1984 with the elimination of the withholding tax on interest payments to foreigners. But in 1983 and early 1984, Treasury officials, both in public and in private, consistently rejected the view that there was any connection between the budget deficit and borrowing from abroad. Their view, rather, was that the capital inflow was occurring in response to a U.S. investment boom in the private sector, inspired by Reaganomics.

I described in my 1984 study, published by the Institute for International Economics four months after I left the staff of the Council of Economic Advisers, how the impetus behind the U.S. campaign for Japanese liberalization launched at the time of President Reagan's visit with Prime Minister Nakasone in November 1983 was rooted in what I considered questionable economic logic on the part of Treasury Secretary Don Regan. This was the notion that Japanese financial liberalization would help

⁶ Assuming that one accepted the basic economic logic and took the low level of national saving as given, the desirability or undesirability of promoting increased capital flow to the United States depended on the relative weight one assigned to the objective of dampening the increase in the interest rate and the consequent crowding-out of business fixed investment and other interest-sensitive sectors, versus the objective of dampening the increase in the value of the dollar and the consequent crowding out of net exports. Bergsten (1982, 1984) argued that, on balance, the exchange rate objective was more important, while Feldstein (1984; and CEA 1984) at the time argued within the Administration (but in opposition to the Treasury view) that the interest rate objective was more important.

promote capital flow from the United States to Japan, rather than the reverse, and would help reduce the corresponding U.S. trade deficit, through an appreciation of the yen against the dollar. Regan acquired this theory from an American businessman in late September 1983.^{7,8} It was not a theory that had previously had adherents in the U.S. Government.⁹

It was explicit at the time, even in publicly available sources, that the primary objective of the campaign launched by the Treasury in October 1983 was to increase the demand for yen assets, thereby increasing the value of the yen and helping to reduce the trade imbalance. The clearest proof of this motivation is that the U.S. and Japanese negotiators were called the "Yen/Dollar Committee," not the "Committee to Finance the U.S. Deficit." The forthcoming Agreement was known by the same name. It is important to remember that promoting increased net Japanese demand for U.S. assets would have been a motive that was not just distinct from promoting a lower yen/dollar rate and lower trade imbalance, but was also inconsistent with it.

⁷ Caterpillar Tractor Chairman Lee Morgan. Morgan based his analysis and recommendations on Murchison and Solomon (1983). It is quite clear that their goal was promoting the flow of capital from the United States to Japan, rather than the reverse; their list of suggested measures for Reagan to urge on Nakasone included, for example, "An increase in the Government of Japan's overseas borrowing with the proceeds converted immediately into yen to assist Japan in financing its substantial budget deficits" (p.25-27).

⁸ The origin of Regan's October 1983 campaign for Japanese financial liberalization in Morgan's visit is also reported by Semkow (1985, p.745).

⁹ Undersecretary Sprinkel had testified as recently as the preceding April that there was no merit to the theory that the Ministry of Finance was using capital controls to keep the yen undervalued. A study by the General Accounting Office released the same month found the same thing.

The faulty component of the argument adopted by Regan was the proposition that the Japanese authorities at the time were using capital controls or administrative guidance to discourage the flow of capital into Japan and to depress the value of the yen. Prohibitions against foreign acquisition of most Japanese assets did in fact exist in the 1970s, but they were formally eliminated in the Foreign Exchange Law of December 1980. The de facto liberalization dated from April 1979. It is evident from a comparison of the Euroyen and Tokyo short-term interest rates that arbitrage was able to eliminate the onshore-offshore differential that existed prior to that date. [See Figure 1.¹⁰] In the early 1980s the objective of the Japanese authorities was, if anything, to dampen the depreciation of the yen, not to promote it.¹¹ Thus it could have been predicted [and was predicted: Bergsten, 1984, CEA, 1984, and Frankel, 1984] that if the Ministry of Finance were to agree to U.S. demands to avoid any remaining interference with international financial flows, the impact would be an acceleration of capital outflow attracted by higher interest rates in the United States, rather than the reverse.

To be sure, other motives for the liberalization campaign were very relevant as well. From the beginning, the appeal of the idea to Don Regan and others in the Administration lay in the political need to be seen beginning to respond to public and Congressional concerns over the rising

¹⁰ Earlier versions of this graph appear in Otani and Tiwari (1981) and Council of Economic Advisers (1984).

¹¹ For evidence that the Japanese government in the early 1980s sought to resist the depreciation of the yen against the dollar, not to exacerbate it, see Council of Economic Advisers (1984), Frankel (1984, 16-25), Funabashi (1988, 89-92), GAO (1983), and Haynes, Hutchison, and Mikesell (1986).

U.S. trade deficit (particularly in a presidential election year), and the desire to do so in a way consistent with free-market ideology. As the first instance of the Treasury attempting to respond to the trade deficit issue via exchange rate policy, in order to fend off protectionist pressures, the Yen/Dollar campaign anticipated the Plaza Accord by almost two years; to this extent, the plan made perfect sense politically.¹² Perhaps, then, it is churlish to argue that the plan did not make sense economically, that its effect was to accelerate Japanese capital outflow, to depreciate the yen (in the short run¹³) and to exacerbate the trade imbalance rather than the reverse.¹⁴ But the political-pragmatism argument only works if it is taken as given that the objective was to help widen President Reagan's 1984 reelection margin. The objective of promoting support for free trade among the American public was not served subsequently, when the net capital flow / trade imbalance was seen to widen.

One could conceivably argue that the strong appreciation of the yen against the dollar that began in March 1985 was caused in part by the

¹² Funabashi (1988, p.75 ff) describes the switch in Treasury emphasis toward bringing down the dollar after James Baker succeeded Don Regan as Secretary in January 1985.

¹³ By the time of my December 1984 study, the yen had depreciated another 6 per cent relative to its level when the campaign was launched.

¹⁴ The rate of Japanese acquisition of long-term assets overseas nearly doubled in 1984 on a gross basis, and continued to rise thereafter. That Japanese financial liberalization in the 1980s, in the presence of higher interest rates available in the United States, has exacerbated the net capital flow and corresponding trade imbalance, is concluded by many authors, including Haynes, Hutchison and Mikesell (1986), Ueda (1987), Fukao (1988), Balassa and Noland (1988, p.124) and Frankel (1988).

Japanese liberalization. But the appreciation is usually attributed to some combination of declining real interest rates in the United States, decreasing marginal willingness on the part of international investors to absorb ever-greater supplies of dollar assets, G-7 exchange rate policies adopted after James Baker and Richard Darman succeeded Don Regan and Beryl Sprinkel at the Treasury, and a reassertion of long-term trends in Japan related to productivity growth in excess of that in other countries. I am not aware of current or former Treasury officials basing a justification of the May 1984 Agreement on an argument that it produced the large appreciation of the yen of 1985-88.¹⁵

More likely, Treasury officials learned in 1987 and 1988 to appreciate the occasional Ministry of Finance use of administrative guidance to encourage Japanese institutional investors to hold more U.S. assets than they would choose on profit-maximizing grounds, in order to keep the dollar from depreciating further than it already had by then. This happened, in particular, in the Spring of 1987 and again in advance of the November 1988 election. Koo (1988, p.8) tells us: "Even though the imposition of such quasi-capital controls [reporting-requirements for Japanese banks handling foreign exchange -- and an implicit threat behind them -- imposed in May 1987 to head off a dollar collapse] was against the spirit of the Yen/Dollar Committee sponsored jointly by the Japanese Ministry of Finance and the US Treasury to deregulate Japanese financial markets, no complaints were heard

¹⁵ Although one could logically make the argument that the Reagan Administration's export of free-market ideology to Japan promoted demand for the yen in the longer run and thus explains its 1985-88 appreciation, this theory would seem to leave one without a ready explanation for the continuing large net capital flows from Japan to the United States.

from the US."¹⁶

Two varieties of the free-market argument are potentially quite sensible. One is that the point of the exercise was to promote the internal efficiency of the Japanese economy. This is apparently one of the things that current U.S. officials have in mind when they speak of the Yen/Dollar Agreement as having been a success, and cite it as a model for the current Structural Impediments Initiative with Japan or Won/Dollar talks with Korea. The typical reaction of an outsider, however, is that the Japanese would not appear to need any advice from the United States on how to run their economy, while the typical reaction of an American would be that the goal of U.S. policy should be to promote the competitiveness of the American economy relative to Japan, rather than the reverse.

The remaining argument is that the point of the campaign was to promote better treatment in Japan of U.S. banks, securities companies, and other providers of financial services. Several measures of this sort indeed appeared on the list that Regan discussed with Finance Minister Noboru Takeshita November 10, 1983, on the occasion of President Reagan's visit to Japan, and in the May 1984 Agreement. This component of the campaign is perfectly analogous to Reagan Administration pressure on Japan at that time to allow the free import of beef and citrus products. There is no question that the initiation of the Yen/Dollar campaign in October 1983 gained political momentum when New York financial institutions responded to a Treasury invitation to contribute a wish-list of proposed measures. There is also little question that the measures which were adopted worked on U.S.

¹⁶ See also Hale (1989, pp.2-4).

service exports in the desired direction.¹⁷ But my claim is that the objective of helping U.S. providers of financial services was secondary to the objective of affecting capital flows and the exchange rate.

4. Negotiations on Korean Financial Liberalization

The Treasury's October 1989 report to Congress concludes with the announcement, "Recently, the Treasury Department and the Korean Ministry of Finance have agreed to initiate talks on financial policies, including the exchange rate system and capital market issues. We hope to encourage a more market-oriented exchange rate system in Korea within the framework of these talks" (p.29). Other than that they are scheduled to begin in January 1990, little more as to the nature of these talks appears definite.

The talks are likely to encompass several areas. The most straightforward category of U.S. proposals will be the removal of

¹⁷ Several qualifications can be noted. First, such measures were not in the interest of U.S. manufacturing (and for this reason, did not appear in the original Murchison-Solomon report). Second, in contrast to recent U.S. efforts to include services in the Uruguay Round of GATT negotiations, these measures may not have been in the interest of promoting the existing liberal international trade regime, as they were negotiated bilaterally and the benefits (such as the decision by the Tokyo Stock Exchange to make a seat available to Merrill Lynch, Don Regan's former company) accrued more to U.S. financial institutions than those of third countries. Third, one variety of the "Yanks hoodwinked again" school argues that the wily Japanese somehow used liberalization to attain more benefits for their banks in the United States and Europe than they granted to U.S. banks operating in Japan. [My skepticism on this last point stems from a view that the recent worldwide expansion of Japanese banks is largely due to the magnitude of Japanese saving, and to the appreciation of the yen, and not to the Yen/Dollar Agreement per se.] Of course, standard theories of the "gains from trade" say that both countries can benefit simultaneously from liberalization.

restrictions on American banks and securities firms doing business in Korea. Such proposals would be conceptually quite similar to corresponding measures in the Yen/Dollar Agreement, and would be a continuation of past U.S. efforts to induce the Koreans to allow American insurance companies to practice in their country. They are clearly in the U.S. economic interest. The standard theory of the gains from trade says that such liberalization would also be in the Korean economic interest. In addition are the responsibilities of membership in the liberal international trading system, which Korea will increasingly have to accept.¹⁸

The other issues that are likely to be included in the talks, financial liberalization and the exchange rate, are less precisely analogous to the situation in the Yen/Dollar negotiations. We consider financial liberalization first, and then the won/dollar issue.

Presumably the ultimate goal behind all three issues -- treatment of U.S. financial institutions, financial liberalization, and the exchange rate-- from the U.S. viewpoint is to help promote the exports of U.S. goods and services. If the U.S. launches a campaign for full liberalization of Korean financial markets, including a removal of existing controls on both international capital inflows and outflows, there is at least the potential that, as with the Japanese precedent, it will have the opposite effect. In other words it is possible that in the absence of restrictions, more capital

¹⁸ Under the existing principles of the liberal international multilateral trading system however, the issue of liberalizing trade in financial services belongs in the Uruguay Round of GATT negotiations, more than in bilateral bargaining. Korea might also be advised to suggest that the international liberalization of services should logically include the United States allowing the import of the services of foreign construction workers at the same time that other countries allow the import of the services of U.S. financial institutions.

would flow out of high-saving Korea than would flow in, which would imply that the trade imbalance would increase rather than decrease. The recent upward pressure on the won and Korean reserves has come from a Korean trade surplus, not a capital account surplus. Indeed, the Koreans have been using their export earnings to pay off their external debt. It won't be long before they become a net creditor country and start buying assets in the United States like the Japanese do. Korea is still a much less wealthy country than Japan or the United States. Nevertheless, it is possible that the Koreans might be on the verge of a transition similar to that undergone by the Japanese earlier. After all, the United States in the 1980s has demonstrated that national saving rates, not levels of wealth or income, directly determine international capital flows and the corresponding current account balances.

On the other hand, it can be expected that U.S. negotiators will not repeat Don Regan's mistake of demanding access by U.S. borrowers as a means of depreciating the dollar. They will probably emphasize U.S. foreign direct investment in Korea¹⁹ and unrestricted admission for American investors wishing to play the Korean stock market. As compared to continued American complaints that Japanese investors can take over American assets more easily than vice-versa, this strategy has a decided advantage: we can still afford to buy some of the assets in Korea. Furthermore the exchange rate effect goes the right direction, assuming that further appreciation of the won is indeed a goal.

4. Won/Dollar Negotiations

¹⁹ Young (1989, p.141).

Over the last several years, the United States has pressured several of the East Asian NICs to allow their currencies to appreciate against the dollar. Korea has responded by appreciating the won since 1987 (and Taiwan its currency, since 1986). But the U.S. Treasury seeks further movement, citing "indications of exchange rate 'manipulation' during the six months since the April report" (p.26).²⁰ Evidently, the financial policy talks will not focus on the level of the won/dollar rate per se. Rather, the Treasury "will encourage the liberalization of Korea's exchange rate system and of the capital and interest rate controls that impede the full operation of market forces." But it seems clear that a goal of this liberalization of the system would be, under current circumstances, to allow the won to appreciate further. The Treasury does say that, parallel with the talks on financial policy, will be negotiations "to press for exchange rate policy to support further external adjustment," i.e. for more appreciation of the won.

In one respect, the case for appreciation of the won has been, and continues to be, less confused than the 1984 argument for appreciation of the yen: the Korean central bank has indeed bought dollars and sold won in foreign exchange intervention, which is not what the Japanese were doing in the early 1980s. So it is at least true that a move to freely-floating exchange rate system would entail appreciation of the won. Also there are some respectable economic arguments for letting the won appreciate, beyond the goal of helping to reduce the U.S. trade deficit. When a country like

²⁰ "Manipulation" appears in quotes in the Treasury report, and might be interpreted as a reference to the Congress' 1988 Omnibus Trade Bill.

Taiwan or Korea attempts to keep the currency from appreciating, it may experience an inflow of reserves too large to sterilize, resulting in undesired monetary expansion and inflation.²¹

However, the case against Korea and the other Asian NICs dampening appreciation of their currencies against the dollar has none of the legal or principled basis that is imputed to it by the Omnibus Trade Act of 1988. Small countries are perfectly free to seek to maintain fixed exchange rates. There is nothing in the Articles of Agreement of the GATT or IMF, nor is there anything in idealized free-market principles, that discourages the attempt to maintain a fixed exchange rate. Indeed, the original goal of the IMF was to promote stable exchange rates. Such fathers of "Supply-Side Economics" as Robert Mundell and Jack Kemp consider a return to exchange rate stability to be essential to their creed. (They actually consider proposals to solve world trade imbalances by depreciating the dollar against Asian currencies to be similar in character to protectionism!)

Even those of us who are more enamored of floating exchange rates for major currencies like the dollar and yen recognize that there is little point in a sufficiently small country -- whether less-developed, newly-industrializing, or fully industrialized -- having a floating exchange rate. The Optimum Currency Area argument of undergraduate textbooks reminds us that for a small open economy like Hong Kong (or, in the limit, the District

²¹ In general, my advice to a less developed country experiencing unwanted reserve inflows and fearing real appreciation of its currency is as follows: (1) liberalize with respect to capital outflows, thus reducing the magnitude of the net inflows, and (2) liberalize with respect to domestic bond markets, thus allowing scope for central bank operations to sterilize reserve inflows. Financial liberalization may indeed be a good idea for Korea.

of Columbia) the advantages of a floating exchange rate (monetary independence, and automatic adjustment of the balance of payments) are probably outweighed by the advantages of a fixed exchange rate (no exchange rate uncertainty, and a credible commitment to low money growth and inflation).

This is not to say that there might not be some valid economic reasons for Korean appreciation. The point is rather that Americans are mistaken to accuse small Asian economies of violating any rules of free-market economics or international commitments when they intervene in the foreign exchange market. The case for negotiating reductions in barriers to international trade has strong justification in the principles of economic theory and of international commitments like the GATT. The case for reducing barriers to international capital flows has weaker justification in principle, both in theory and under international commitments, but is still respectable. The case for abstaining from intervention in the foreign exchange market has almost no such basis in principle at all. When Americans apply terms like "unfair" or "manipulate" indiscriminately, they undermine the rules and principles that truly are important.

As Korean Minister of Finance Il SaKong (1989, p.15) has pointed out, pressuring Korea into further appreciation of the won could undermine import liberalization there by adding to domestic opposition:

Korea's first order of business at this point must be to eliminate existing market-distorting elements. In this regard, Korea has been doing its utmost to get rid of nontariff barriers still remaining in the economy and to reduce the average tariff. By so doing, Korea will be able to import more from the United States, provided that US firms take full advantage of these measures. This, more than anything else, will

help to restore a favorable bilateral trade balance. Accelerating the appreciation of the Korean won would act to preserve, and perhaps heighten, distortions in the economy, with negative ramifications for both Korea and the United State.

Americans would be as well-advised as Koreans to keep clear the distinction between policies that are based in principle and those that are based in expediency.

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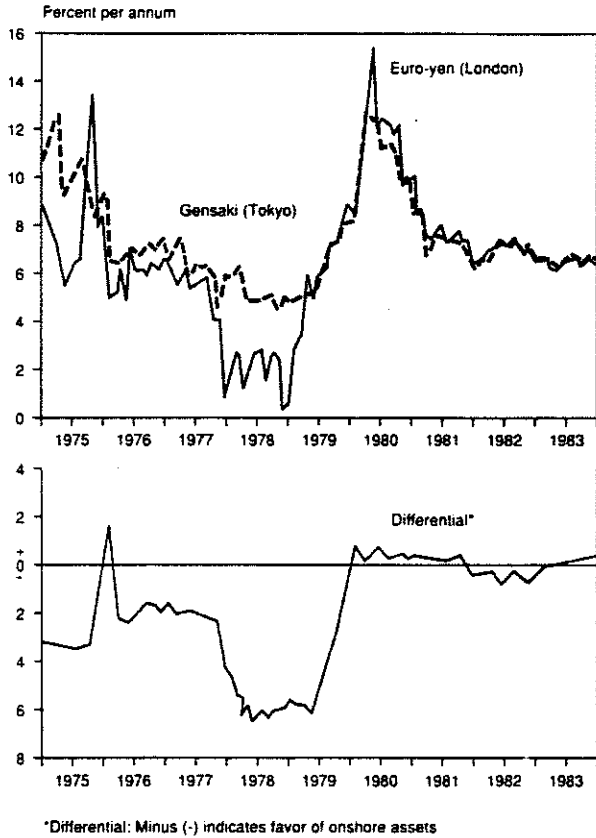
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FIGURE 1 Financial Liberalization in Japan

In the 1970s, capital controls prevented foreign residents from acquiring assets in Japan, which paid a higher return than equivalent yen assets offshore. In 1979, these controls were removed, and arbitrage caused the interest differential to fall.

Japanese and Euro-yen interest rates (3-month)



J. Frankel, *The Yen/Dollar Agreement*, Washington, D.C.: Institute for International Economics, December 1984.

Source: R.Caves, J.Frankel, and R.Jones, World Trade and Payments (5th edition, Scott Foresman) Jan. 1990.

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