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April 1996
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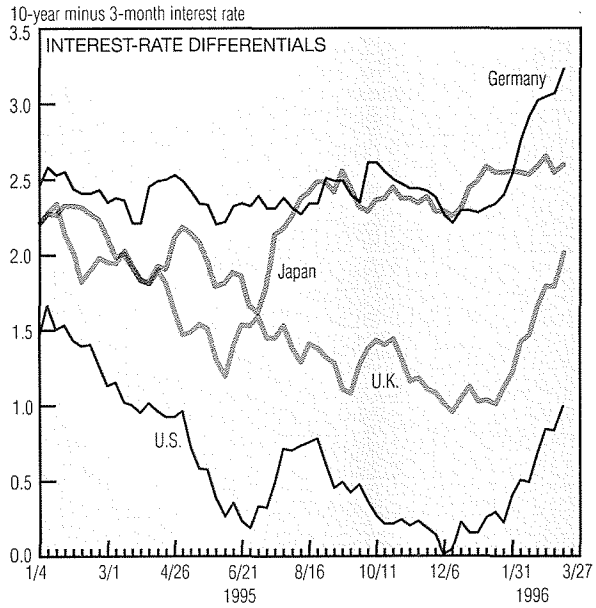
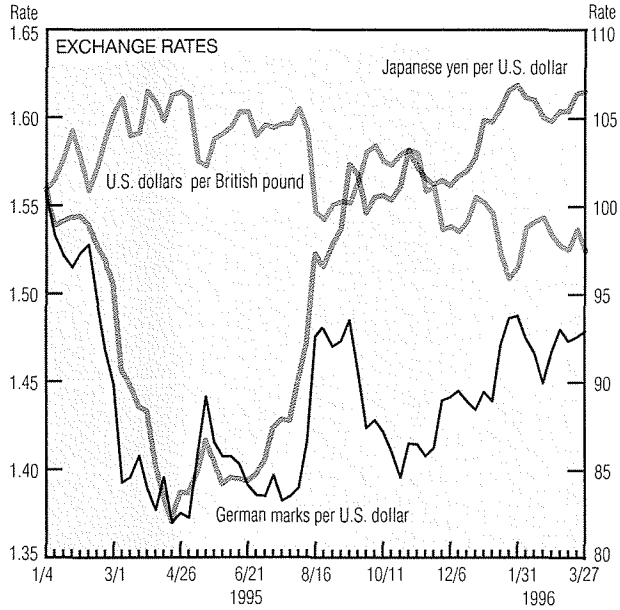
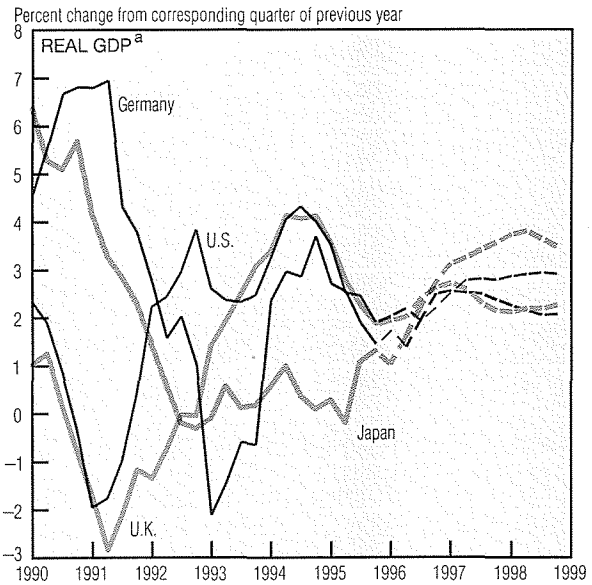
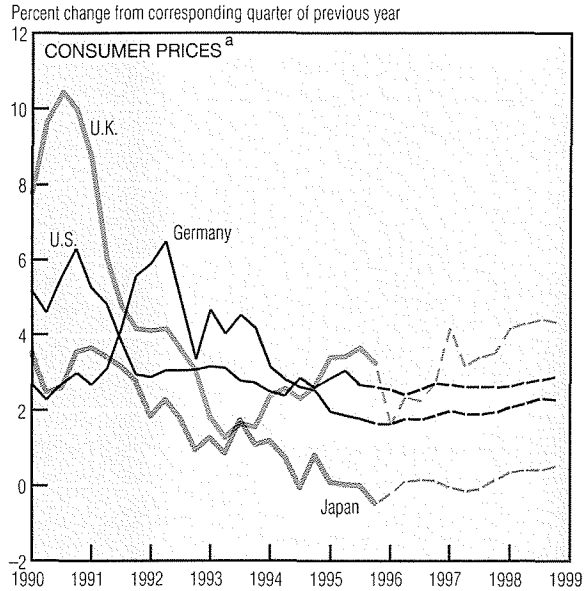
Exchange Rates and Interest Rates









a. Dashed lines represent DRI forecasts as of March 1996.
SOURCES: DRI/McGraw–Hill; and Board of Governors of the Federal Reserve System.

Since the end of 1995, the difference between long- and short-term interest rates has been widening in the U.S., Japan, Germany, and the U.K., possibly because short-term rates are expected to rise in all these countries. Higher short-term rates could result from stronger real economic activity or from a general tightening of monetary policy. However, although recent preliminary signs of economic strength in Japan and Germany led some observers to expect short-term rates to tighten, subsequent data releases indicated weaker conditions.

Higher anticipated inflation is another possible reason for the widening gap between long- and short-term interest rates, but inflation has been, and continues to be, low in all four countries.

Short-run movements in exchange rates should be related to changes in short-term interest rates; however, over longer periods of time, exchange-rate movements should be related to underlying factors (referred to as fundamentals). Since April 1995, the yen has been weakening against the dollar, possibly because Japan's current account balance with the U.S. has fallen. Although Japan's growth rate in real GDP is now the lowest of the four countries, it is forecast to improve markedly over the next three years. On the other hand, the inflation rate for Japanese consumer prices is expected to remain low.