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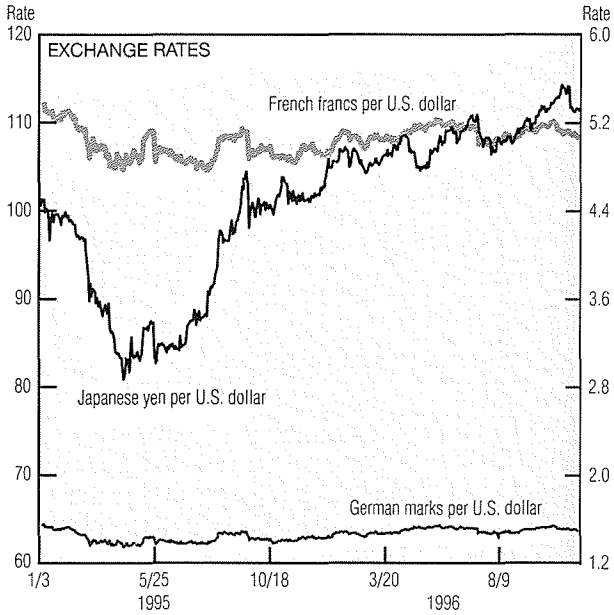
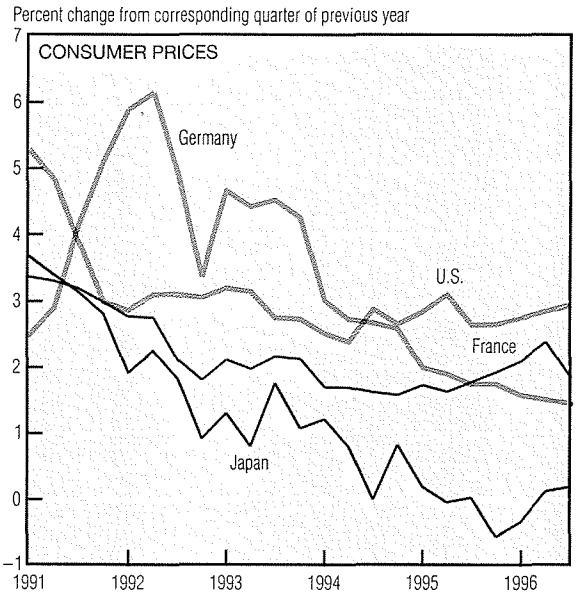
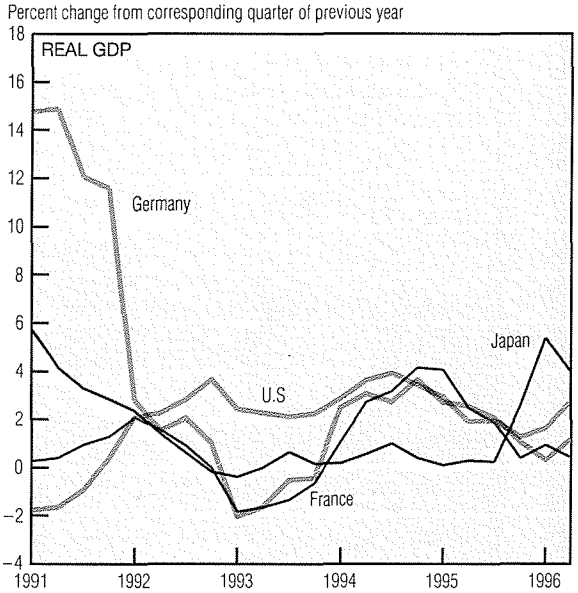
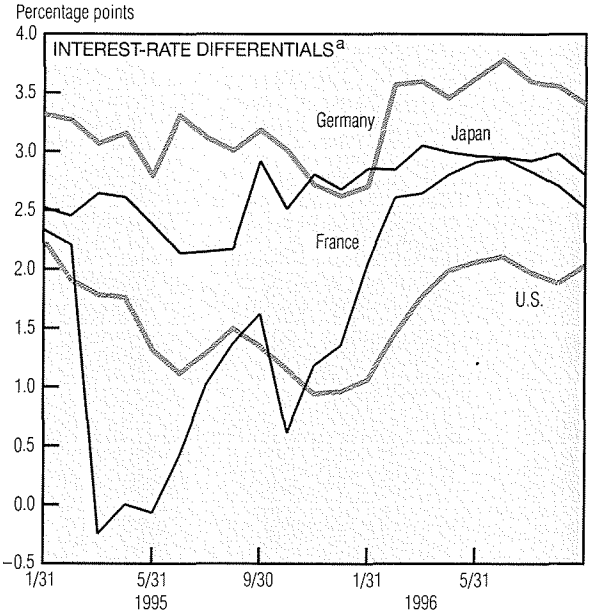
International Developments









a. 10-year minus 3-month interest rate.
NOTE: Prior to January 1991, German data represent West German figures.
SOURCES: DRI/McGraw-Hill; and Board of Governors of the Federal Reserve System.

Overall, the international value of the dollar has changed little over the last month, despite the fact that both short-term and long-term interest rates have fallen more in the U.S. than in most industrialized countries. Market observers attribute the strengthening of the dollar against the yen to disappointment about the prospects for Japanese monetary tightening. This in turn is related to the perception that the new Japanese government is less likely to soften the existing proposals for fiscal contraction.

In several industrialized countries, high levels of unemployment coexist with subdued consumer price inflation. Despite the previous depreciation of the yen, which would be expected to boost domestic prices, the 12-month Japanese inflation rate is near zero. Unexpected upward price pressure would increase the perceived likelihood of monetary tightening in any nation and thus would boost the value of its currency.

Recent indicators point to continued economic growth in Germany and Japan. However, the Bundesbank has indicated that monetary easing is not imminent, despite an unemployment rate of 10.4% in unified Germany. This, in combination with subdued inflation numbers, might explain the drop in German long-term interest rates. Although long-term rates fell even more in Japan, growth there may be boosted as the yen depreciation enhances net exports.

The French economy surged temporarily in the third quarter, but consumer confidence is low, partly because of the nation's 12.6% jobless rate—a post–WWII high. French short-term rates have been allowed

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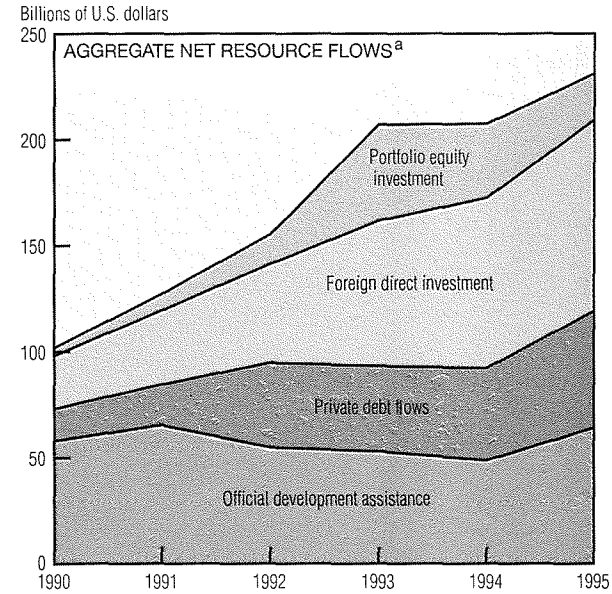
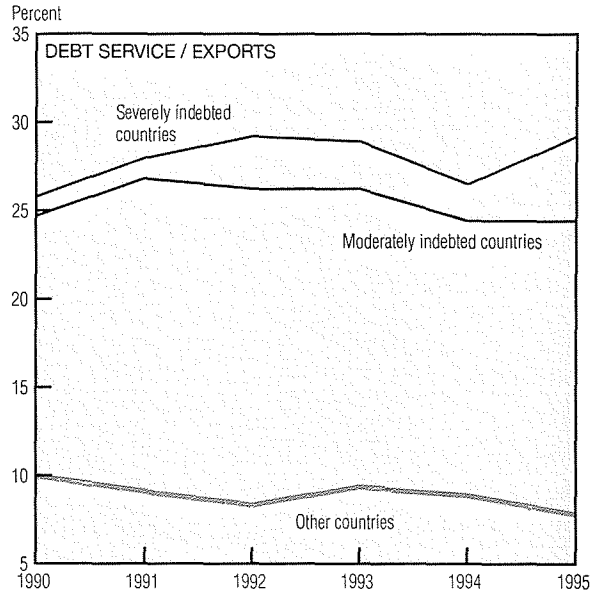
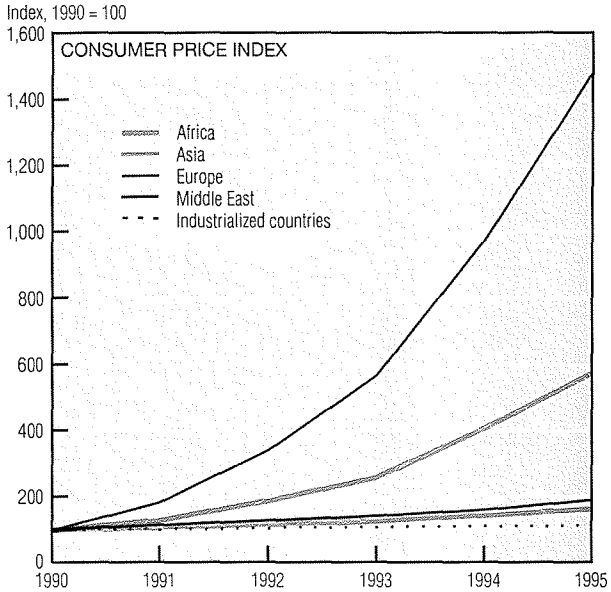
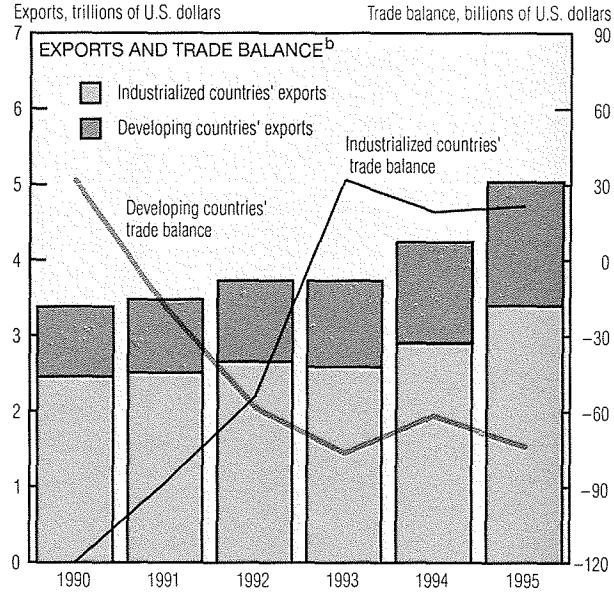
International Developments (cont.)









a. Aggregate net resource flows equal loan disbursements minus principal repayments plus foreign direct investment, portfolio equity flows, and official grants.
b. The trade balance is calculated as merchandise exports minus imports.
SOURCES: International Monetary Fund, *International Financial Statistics*; and The World Bank, *World Debt Tables: 1996*, vol. 1.

to fall more than those of Germany or Japan.

World Bank data indicate that aggregate net resource flows to developing countries continued to advance rapidly in 1995, increasing 11.5%. Excluding the financial aid given to Mexico, however, growth in official development assistance slowed. Smaller increases in private flows are mainly due to declining portfolio equity investment. However, foreign direct investment continued a steady upward trend.

The decline in equity flows has been attributed to three major factors: the increase in U.S. interest rates, the so-called "tequila effect," whereby the Mexican economic crisis led to a deterioration in investors' confidence in other developing countries, and the runup in the U.S. stock market. However, equity flows to developing countries are expected to rebound, though not necessarily to rates reached in 1990–93, when they increased tenfold.

The strength in foreign direct investment, which includes investment in productive capacity, may well continue, as it is part of the globalization of production. A continuation of privatization efforts supports this trend. The decline in official assistance, on the other hand, is a serious concern—especially for countries perceived as poor credit risks, since they cannot shift from official to private sources of finance.

In some nations, soaring inflation rates may indicate that policy reforms are required before private flows can be increased. However, a variety of official actions, including debt rescheduling or debt forgiveness, might facilitate the implementation of effective policy reforms in debtor countries.