The spread between long-term and short-term interest rates has expanded during most of 1996 in the U.S., Germany, and the U.K. Over the last month, this widening has stemmed from higher long rates, reflecting signs of economic strength and perhaps higher expected short rates. Despite some evidence of renewed vigor in Japan, interest rates have not increased during this same period. The dollar has gained ground against the yen in spite of periodic expectations of Japanese monetary tightening. Recent statements suggest that Japan’s central bank is still attempting to sustain the nation’s recovery with low rates.

The dollar has generally risen against the German mark this year on signs of a strengthening U.S. economy, but recently dropped in the wake of reports showing renewed German growth. The recent appreciation of the British pound can be partially explained by the nation’s continued moderate expansion. Short-term interest rates have fallen over the past month, and the inflation rate continues to decline.

Inflation pressures generally remain subdued. Consumer prices in Japan fell over much of the last year, but have been rising since January. Inflation in Germany remains stable, and the U.S. has seen only a slight uptick.

Foreign exchange rates react to news about both trade balances and economic strength or weakness, while trade balances are in turn influenced by exchange rates. However, these reactions often take time and are complicated by the uncertainty surrounding future economic policies. Thus, it is not surprising that the Japanese trade surplus has declined despite weakness in the yen, while a first-quarter deterioration in the U.S. balance has accompanied strength in the dollar.