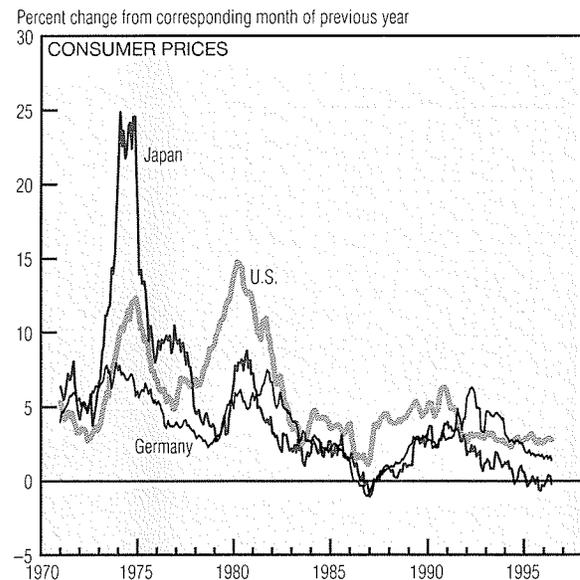
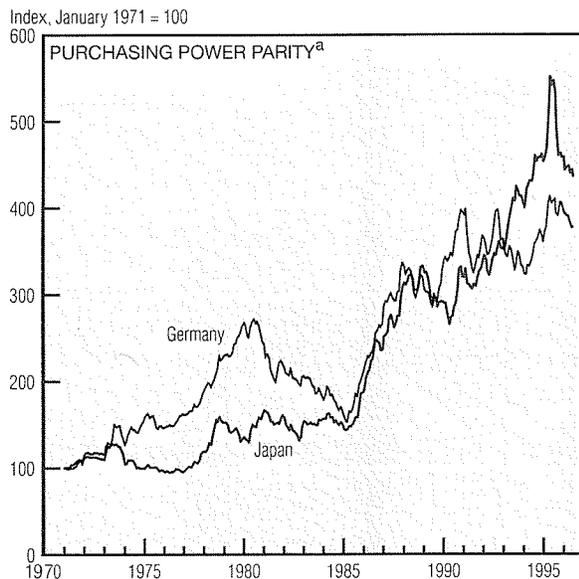
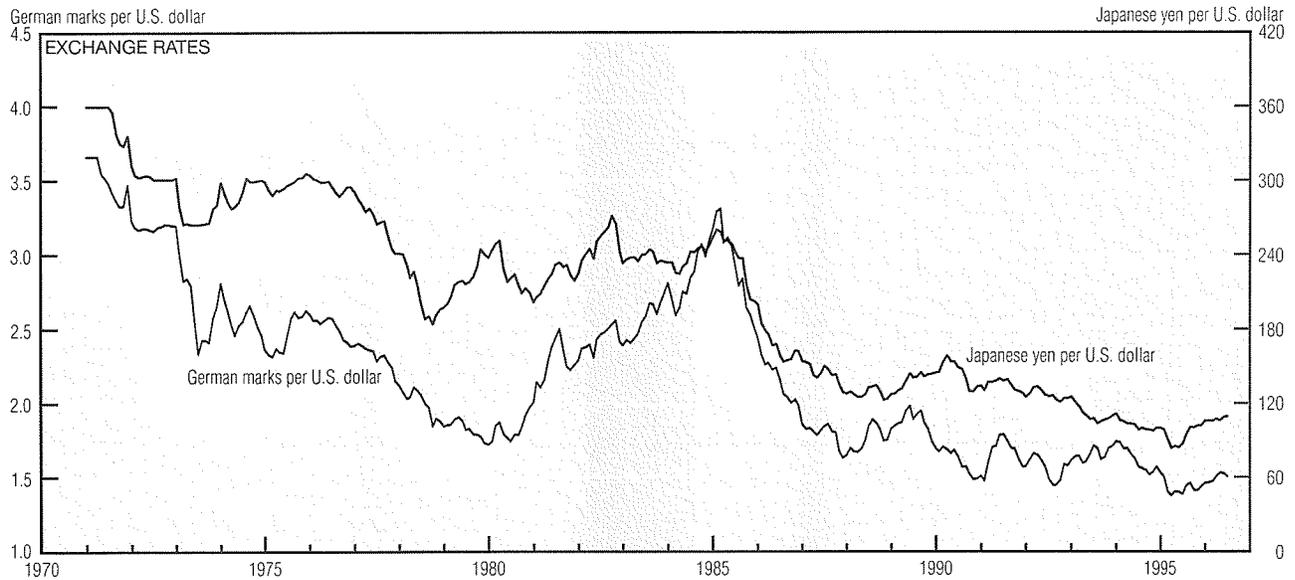


International Developments



a. Purchasing power parity is calculated by combining exchange-rate changes with Consumer Price Index movements for the U.S. and Japan or Germany, respectively.

NOTE: Prior to January 1991, German data represent West German figures.

SOURCES: DRI/McGraw-Hill; and Board of Governors of the Federal Reserve System.

Nominal exchange rates fluctuate substantially and often seem unrelated to short-run movements in such fundamentals as income or trade balances. Nonetheless, certain long-run relationships involving exchange rates may be reliable. In particular, many economists view exchange rates as responding to differences in price levels. However, exchange rates may take more time to respond fully to price-level differences than once was thought. Since 1971, U.S. infla-

tion rates have usually been higher than Germany's or Japan's, and the dollar has weakened against both the mark and the yen.

Calculations of purchasing power parity indicate that relative inflation rates and exchange-rate movements have a combined effect on the U.S. competitive position relative to Germany and Japan. Both strength in the dollar and higher U.S. inflation rates weaken the U.S. position. The German mark has held its ground against the dollar since 1992, despite

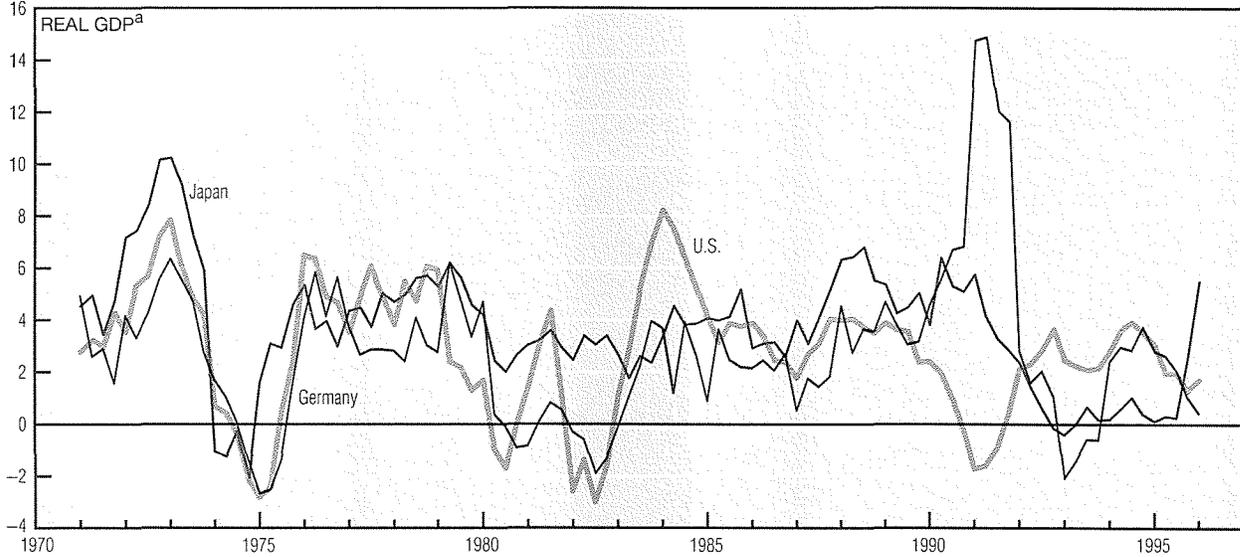
higher inflation rates in unified Germany. Over the same period, the yen has generally gained against the dollar, with lower Japanese inflation rates. Thus, U.S. parity against Germany has improved relative to our position against Japan.

Since 1995, both the mark and the yen have weakened against the dollar. Although U.S. inflation rates have been higher, the relative strength of the American economy makes the dollar an attractive investment.

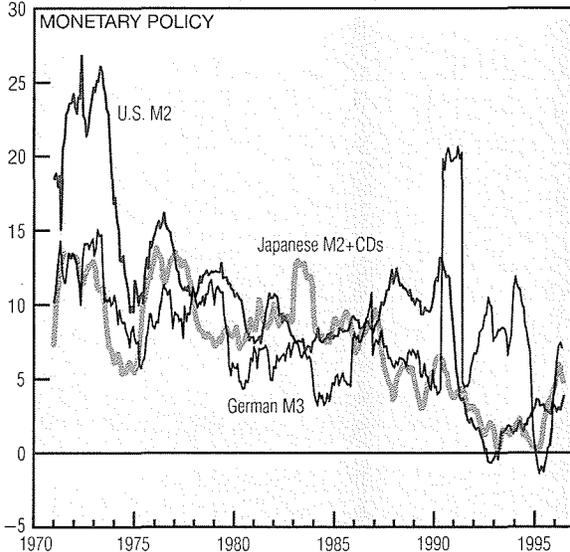
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International Developments (cont.)

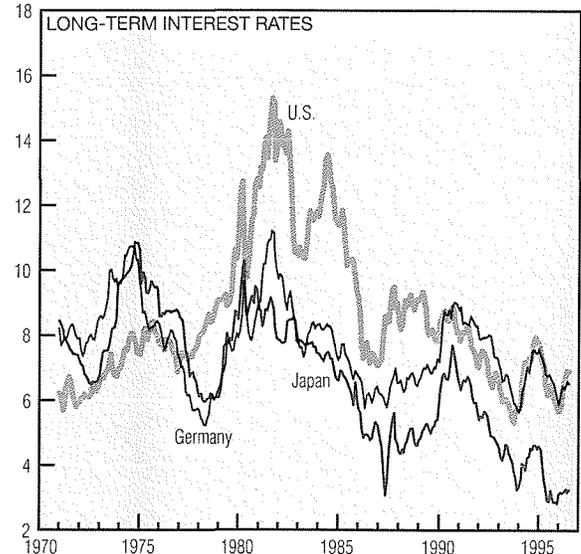
Percent change from corresponding quarter of previous year



Percent change from corresponding month of previous year



Percent



a. Seasonally adjusted.

NOTE: Prior to January 1991, German data represent West German figures.

SOURCES: DRI/McGraw-Hill; and Board of Governors of the Federal Reserve System.

Long- and short-run movements in exchange rates, interest rates, and inflation rates may be connected through the mechanism of monetary policy. Higher rates of money growth tend to produce higher inflation, and the expectation of greater inflation increases long-term interest rates as lenders demand compensation for lost purchasing power. News that a central bank may tighten tends to boost the value of a nation's currency as people anticipate higher short-term interest rates.

Since unification, Germany has had higher rates of money growth

than both Japan and the U.S., yet by 1994 German economic growth had recovered to near the U.S. rate. And while Japanese money growth has been only slightly below that of the U.S., Japan's long-term interest rates have been much lower. These patterns may be related to unanticipated developments in output. German GDP dropped sharply after unification, but then rebounded. Japanese economic growth finally began to recover in late 1995 from problems caused by bad assets at many of the country's financial institutions.

Speculation that the Bank of Japan

may tighten in response to strong first-quarter growth has supported the yen, while Germany's ongoing sluggishness has led to talk of loosening and has weakened the mark. Efforts by central banks to stimulate growth by manipulating short-term interest rates are quickly reflected in lower currency values if they are perceived as an acceptance of higher inflation. According to this view, the lower interest rates in Japan might be due to that nation's willingness to hold the line against inflation despite a few years of less-than-stellar economic growth.