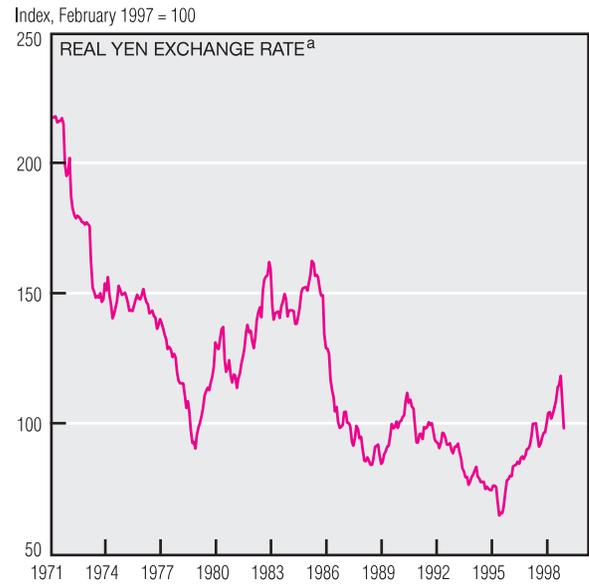
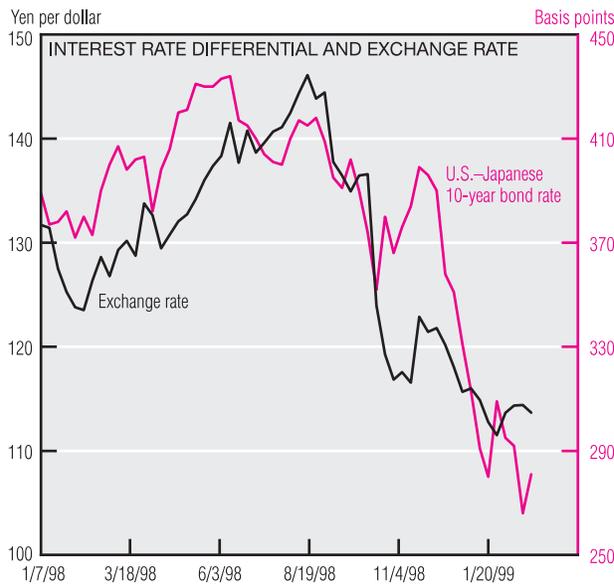
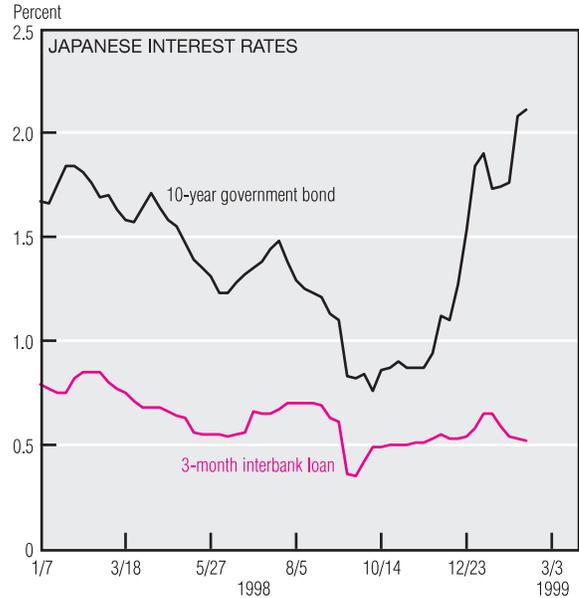


# The Rising Yen



a. The real exchange rate adjusts the nominal exchange rate for inflation in both countries. A decline (rise) represents a real appreciation (depreciation) of the yen against the dollar.

SOURCES: Board of Governors of the Federal Reserve System; and International Monetary Fund, *International Financial Statistics*.

The U.S. dollar has depreciated 18% against the Japanese yen since August 1998. More than half of the decline occurred in late October, as hedge funds and other international investors scrambled to stop losses on short yen positions. Investors' swift actions, while increasing market volatility, were a response to emerging news of changes in Japanese fiscal policy.

Last summer, as its economy slipped deeper into recession, Japan

announced a series of fiscal initiatives. The market, however, was not impressed with the initiatives' overall size or the lack of permanent tax cuts, and remained unconvinced of Japan's willingness to tolerate large budget deficits. An additional installment in November seemed to add credibility, and yields on long-term government bonds rose sharply. In contrast, U.S. long-term bond yields fell. The narrowing rate differential seems to explain the yen's appreciation since August.

Dollar movements against the yen since 1995—its initial appreciation and its more recent depreciation—have tended to offset inflation differentials between the two countries. Upward and downward movements in the real exchange rate confer a competitive advantage on Japan and the U.S., respectively—especially deviations from an index value of 100, which is consistent with purchasing power parity. Opposite movements eliminate these gains.