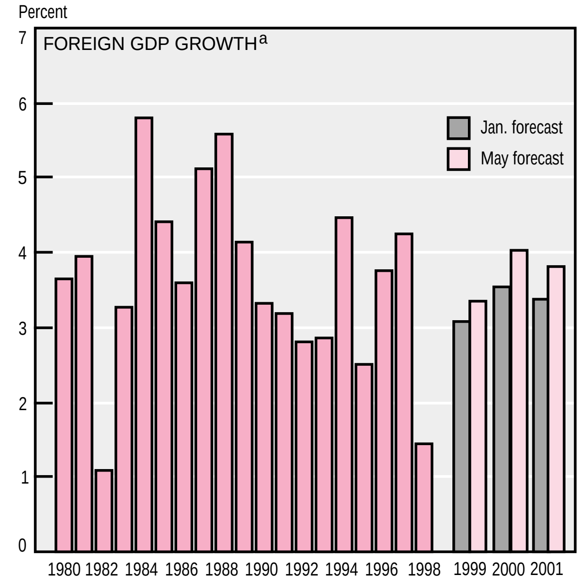


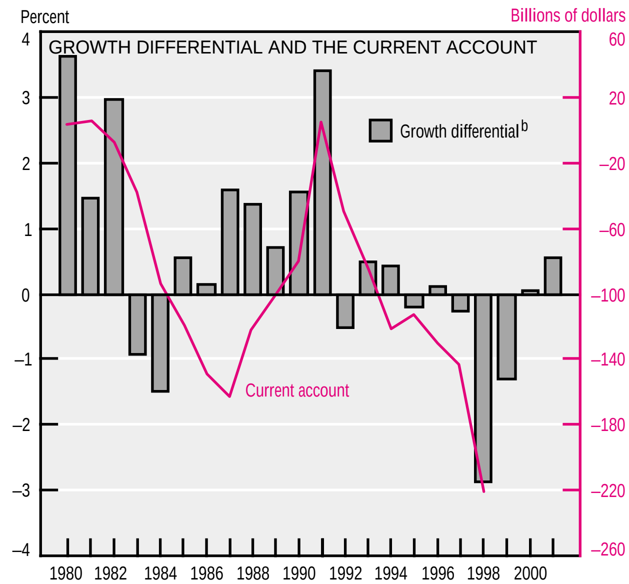


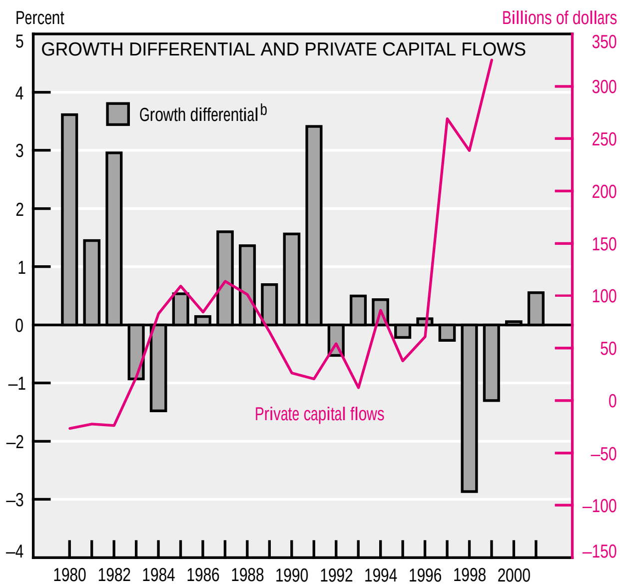


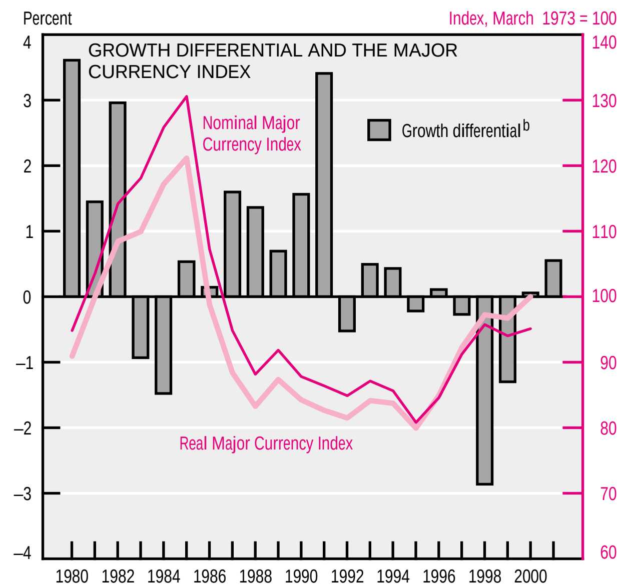


a. Foreign GDP growth is the trade-weighted average growth rate for the top 15 U.S. trading partners in 1992–97: Canada, Japan, Mexico, Germany, U.K., China, Taiwan, Korea, France, Singapore, Italy, Hong Kong, Malaysia, the Netherlands, and Brazil.
b. The GDP differential equals the difference between foreign and U.S. GDP growth.
SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Organisation for Economic Co-operation and Development, *Economic Outlook;* International Monetary Fund, *International Financial Statistics*; DRI/McGraw–Hill; *Blue Chip Economic Indicators*; and *The Economist*, May 6–12, 2000.

Over the past three years, financial turmoil in Asia, Russia, and Brazil encouraged foreign investors to shift large amounts of funds into the U.S., prompting a broad-based appreciation of the dollar. Now that financial calm has returned to emerging markets and foreign economic growth is quickening, some analysts maintain that the dollar will inevitably reverse direction. They contend that faster foreign economic growth will bring rising returns on investments abroad relative to those in the U.S. and an unavoidable diversification out of dollar-denominated assets.

It is true that U.S. capital flows are correlated with the growth differential in a manner that is generally consistent with this story. When foreign economic growth surpasses economic growth in the U.S., net inflows of foreign capital to this country slow.

In contrast to the story, however, dollar exchange-rate movements are not related to the growth differential in a systematic way. As growth abroad accelerates, foreign demand for our export goods increases, and the current-account deficit tends to narrow. All else held constant, this should encourage a dollar appreciation. Consequently, the exchange-rate pattern that emerges as foreign economic activity expands will depend on whether the associated net capital movements dominate the net trade pattern. Any outcome is possible.