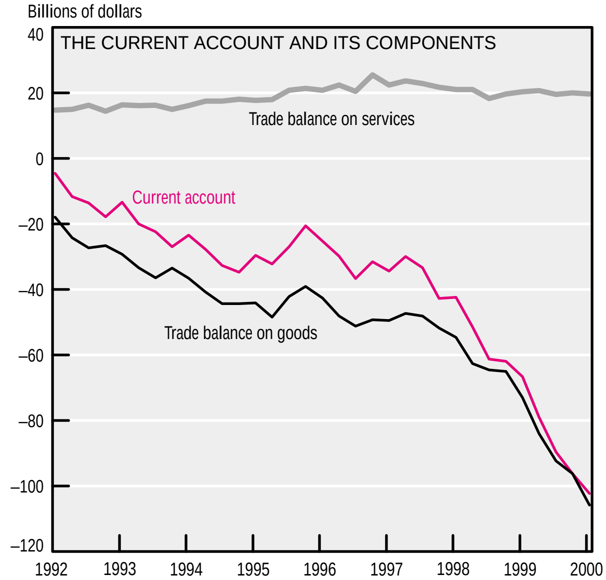
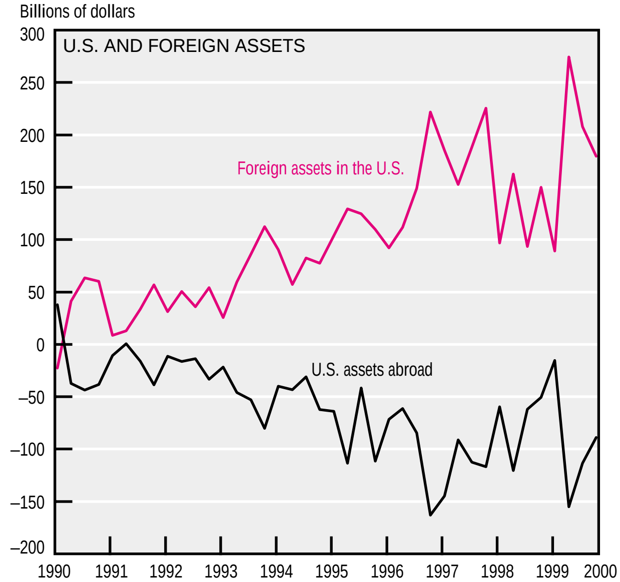
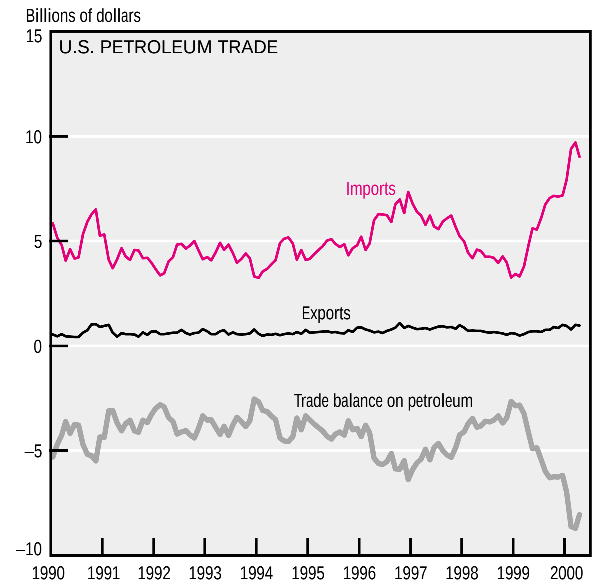
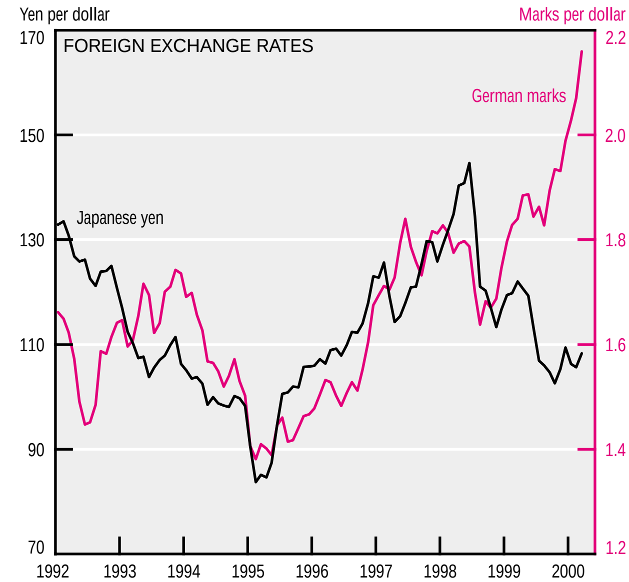
International Developments









SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Deutsche Bundesbank; Japan Securities Dealers Association; and Association of Call and Discount Companies/Nihon Keizai Shinbun (Nikkei).

The U.S. current-account deficit widened from $96.2 billion in 1999:IVQ to $102.3 billion in 2000:IQ. This movement reflects a decrease in the surplus on the services balance combined with an increase in the goods deficit. This rapidly increasing goods deficit, resulting primarily from imports to the U.S., almost completely accounts for the sharp increase in the current-account deficit since 1997. Imports have been boosted by rising incomes and by a strong dollar that makes imports to the U.S. cheaper and exports more expensive.

The sustainability of the U.S. current-account deficit concerns many analysts. The counterpart of this deficit is a strong capital inflow, which can be seen as financing consumption of imports in excess of exports. One can also view capital inflows as a vote of confidence in the U.S. economy that might, in turn, explain the strength of the dollar. This latter view implies that the trade deficit is less worrisome so long as the dollar remains strong.

The dollar's international value is also related to differences in interest rates between countries. A major concept in international finance is *uncovered interest rate parity*—the notion that interest rate differentials must be balanced by expected changes in currency exchange rates. This concept implies, for example,

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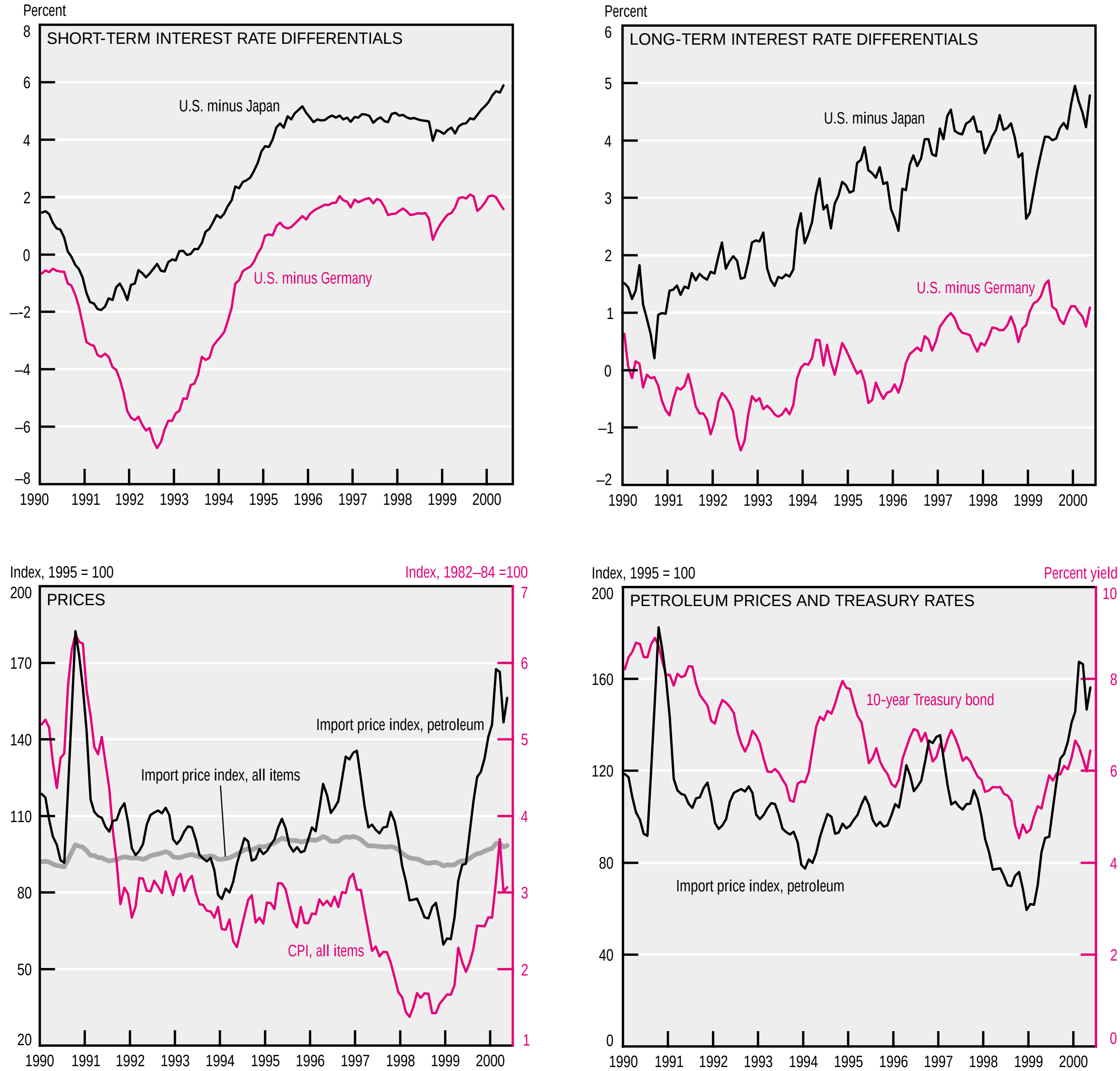
International Developments (cont.)



SOURCES: U.S. Department of Commerce, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; Deutsche Bundesbank; Japan Securities Dealers Association; and Association of Call and Discount Companies/Nihon Keizai Shinbun (Nikkei).

that if U.S. interest rates are higher than Japanese, market participants must expect the yen/dollar exchange rate to decline. According to this view, recent increased differentials between U.S. interest rates and those of Germany and Japan suggest that the dollar is expected to depreciate more than before.

Researchers have found little evidence of a link between short-term interest rate differentials and exchange rate movements. However, there is stronger evidence of a link between longer-term interest rates and longer-term movements in currency values. Thus the recent, relatively abrupt increase in the difference between 10-year interest rates in the U.S. and those in Germany and Japan might indicate expectations of a longer-term decline in the dollar.

Petroleum products form a major component of the recent decline in the U.S. goods balance. The volume of petroleum imports has risen sharply since 1999, with prices increasing at a faster rate than other import prices or even overall consumer prices.

The importance of petroleum price increases depends largely on whether they are expected to be temporary. The positive correlation between the Import Price Index for petroleum and the 10-year U.S. Treasury bond yield is consistent with an increase in expected inflation imbedded in the bond yield. On the other hand, interest rates may have risen partly in anticipation of increased inflation.