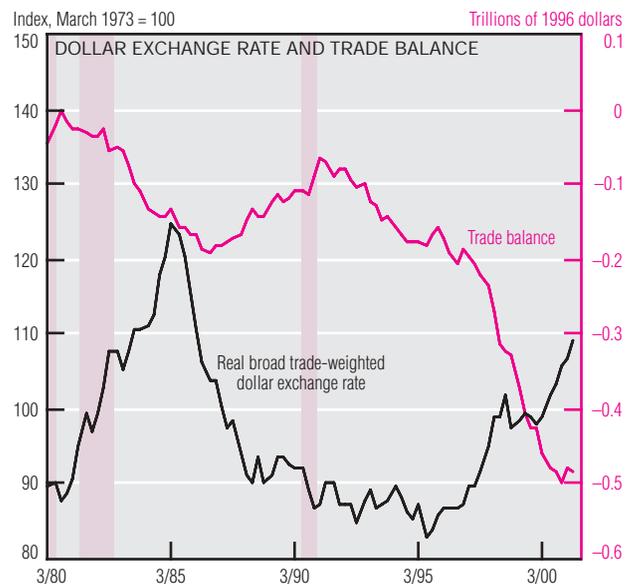
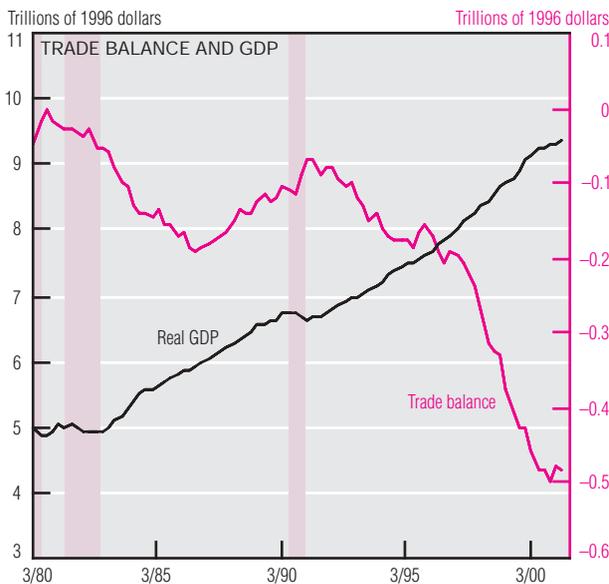
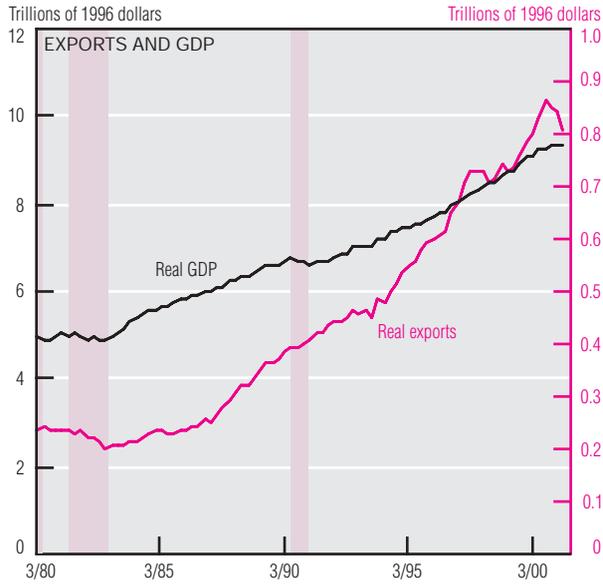


International Developments



NOTE: Shaded areas indicate recessionary periods.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis; and Board of Governors of the Federal Reserve System.

The U.S. trade deficit on goods and services increased \$0.9 billion in June, from \$28.5 billion in May. This change combines declines in both imports and exports, probably reflecting a decline in economic activity here and abroad. Among export categories, capital goods declined most. One key to interpreting this development is how quickly the recent drop in the dollar's value abroad will boost U.S. exports and dampen imports.

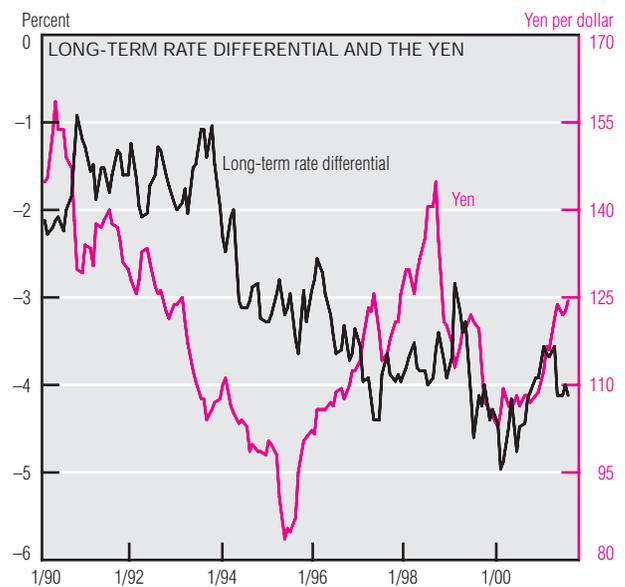
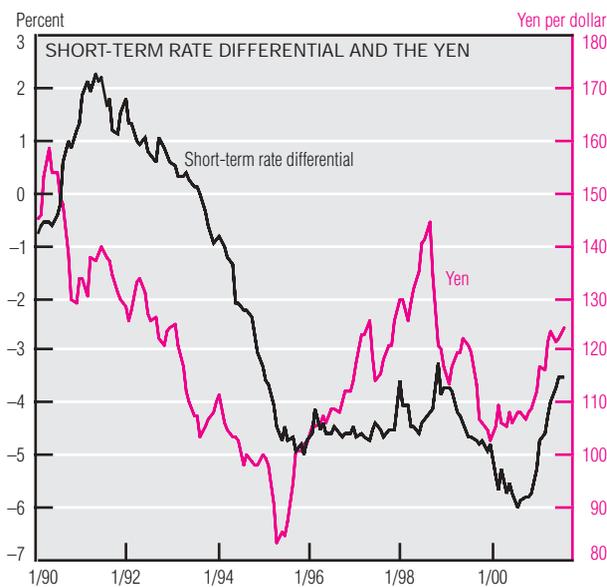
In some quarters, steady deterioration in the U.S. merchandise trade pattern since 1990 has been seen as a

benign expression of the economy's impressive vitality. The real dollar exchange rate's strengthening since 1995 might be thought consistent with strong capital flows into the U.S., but its consequence is a weakening trade position. If the inflows are used to fund productivity-enhancing investments, then it is more likely that investors will continue lending into the U.S., and that the trade deficit can coexist with a strong dollar. However, as events in East Asia in the late 1990s demonstrated, the direction of capital flows can suddenly change to the

detriment of the affected countries' economic strength.

Financial markets' reactions to trade-balance news often center on the implications for GDP. Interest rate movements, especially for short maturities, are often linked to economic strength as well. The relationship between interest rates and exchange rates, in turn, is a key to analyzing capital flows and the consequent sustainability of trade positions. Future exchange rate movements might be linked to differences in two currencies' interest rates through a
(continued on next page)

International Developments (cont.)



NOTE: The interest rate differential is calculated as the foreign interest rate minus the U.S. interest rate.

SOURCES: Board of Governors of the Federal Reserve System; European Central Bank; Bank of Japan; and Association of Call and Discount Companies/Nikon Keizai Shinbun (NIKKEI).

construct called uncovered interest parity (UIP), which says that a market in equilibrium must expect the currency with higher interest rates to depreciate and so equalize expected rates of return in the two currencies. However, the evidence on UIP is mixed at best, especially for shorter-term rates.

Since at least early 2000, the dollar's interest rate reductions have outdistanced those of the euro. UIP would imply that the euro would be expected to decline against the dollar, as has generally been the case. However,

the euro has been falling since early 1996, despite a decline in the interest rate differential. On the long end of the maturity spectrum, the euro shows roughly the same pattern.

In the case of the yen, dollar short-term rate declines have accompanied a stronger dollar. On the other hand, the long-term rate differential has fallen in recent months. In this case, UIP would imply that markets expect the yen to rise. However, for about two years, starting in 1996, when the yen was in decline, the long-term rate differential also was falling.

One reason for the difficulty of using UIP to analyze exchange and interest rate movements is that monetary policy stances may change. For example, in recent years the dollar's interest rate increases, which were interpreted to mean that monetary policy was holding the line against price pressures related to economic strength, supported capital inflows and trade deficits. On the other hand, in East Asia in the late 1990s, where interest rate increases were used to stem capital outflows, UIP might be consistent with a drop in the value of beleaguered currencies.