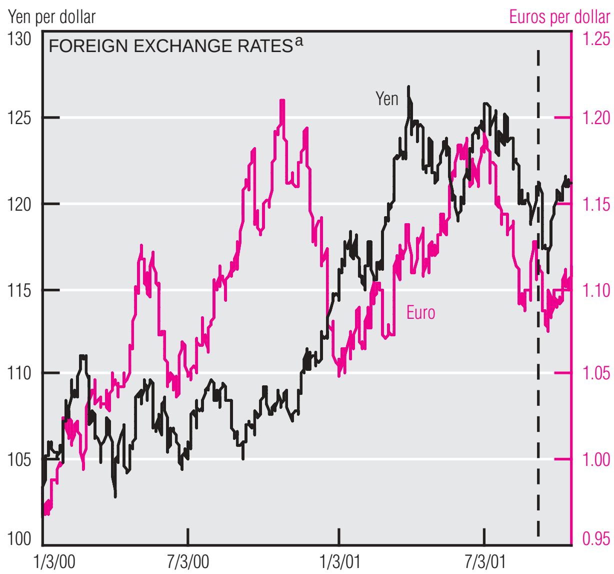
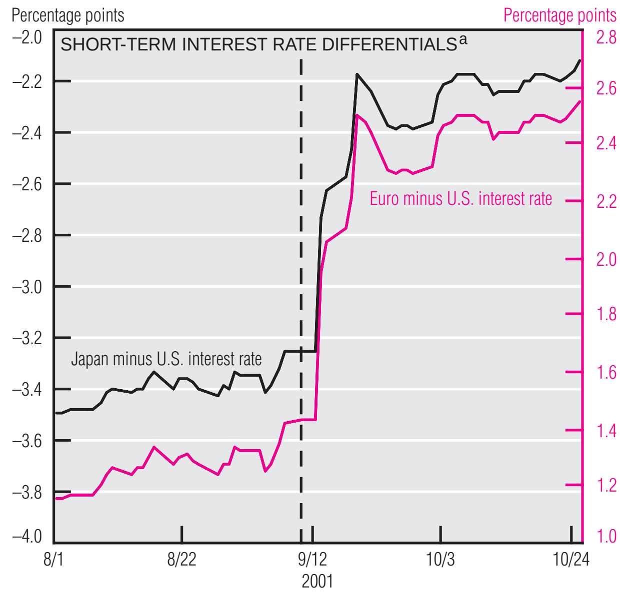
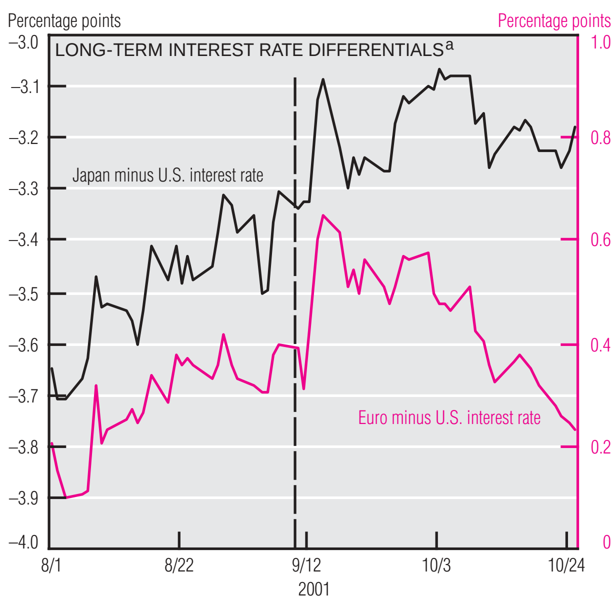
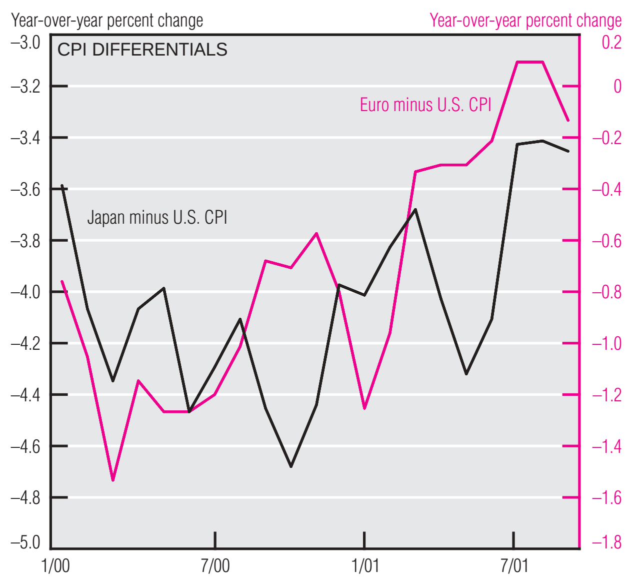
International Financial Markets









a. Dashed line indicates September 11.

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

The yen/dollar and euro/dollar exchange rates, which fell sharply soon after September 11, have largely recovered. An increase in the risk-premium component of the rate of return required by international investors may have been an important factor in their decline.

Both exchange rates were probably also affected by the sharply increased difference between foreign and U.S. interest rates resulting from U.S. rate reductions made immediately after the tragedy. The theory of uncovered interest parity says that the currency of a country with high interest rates is expected to decline by an amount equal to the differential in rates over a horizon equal to the rates' maturity. U.S. short-term rates exceed Japan's, so the U.S. rate's decline implies that the dollar is expected to depreciate over the short term. A drop in the dollar's value, if there is no change in its expected future level, would accomplish this adjustment.

European short rates are higher than those of the U.S., implying that a larger appreciation is expected for the dollar. This could also be accomplished by a decline in the dollar's value, if expectations about its future value remain unchanged. Any deviation from the relationship between interest differentials and expected changes in exchange rates might be explained by an alteration in the risk premium.

The market also has focused on possible global economic weakening. The widening gap between U.S. and foreign long-term rates supports the view that future reductions are more likely in the U.S. than abroad. Prospects for moderating inflation could influence foreign rate reductions strongly.