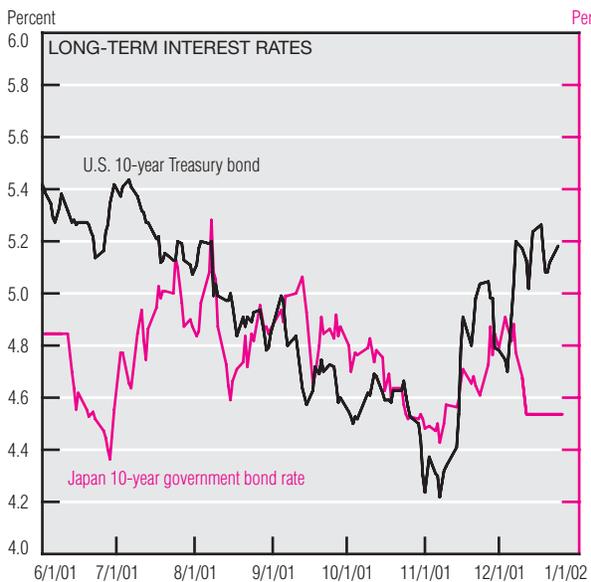
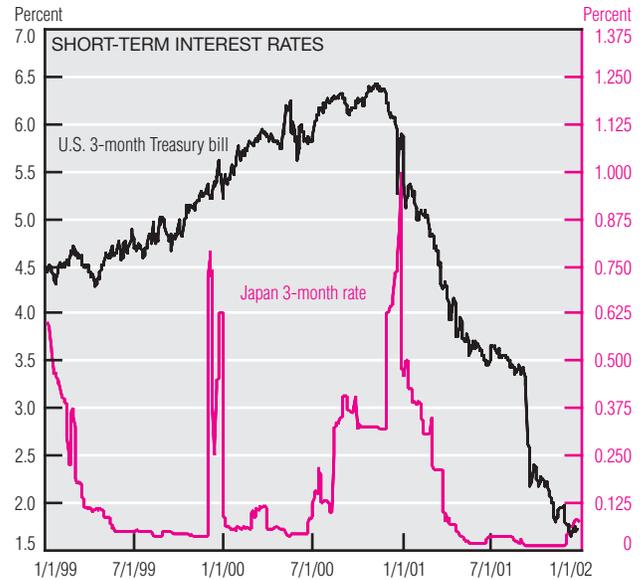
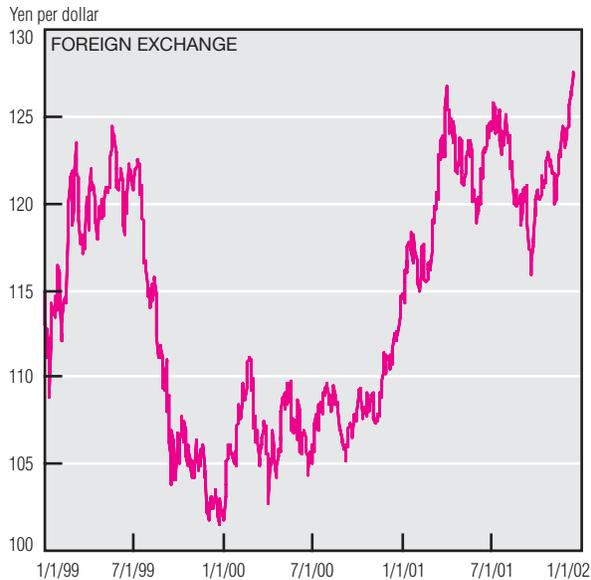


# Japan's Economy



SOURCES: Board of Governors of the Federal Reserve System; Japan Securities Dealers Association; Association of Call and Discount Companies/Nihon Keizai Shinbun; Japan Ministry of Public Management, Home Affairs, Post, and Telecommunications.

In mid-December, the Japanese yen began another bout of weakening against the dollar. In analyzing exchange rate movements, one important concept is uncovered interest rate parity (UIP), by which the movement in the exchange rate expected by the market must equal the interest rate differential between the two countries. While U.S. short-term interest rates have continued to decline, Japan's short-term interest rates have shown little movement since mid-2001. In this case, UIP would imply that the market now

must expect a smaller movement in the yen-to-dollar exchange rate. Many studies, however, have failed to provide evidence that supports the UIP concept. One possible explanation for this contradiction lies in the movement of risk premiums.

In early December, selling pressure against the yen appeared to be strong. Continued news of Japan's economic weakness did not seem to be undermining its currency, but the possibility that U.S. rate declines might soon come to an end may have been weighing against the yen. The November increase in the U.S.

10-year interest rate could be taken to indicate an expected increase in U.S. short-term rates.

Despite a relatively sharp increase in Japanese M1 over the course of 2001, the Bank of Japan has continued to be under pressure either to provide further monetary easing or to purchase foreign assets. From the market's point of view, the likelihood of such policy moves seemed to increase in mid-December, when Japanese officials made statements that could be viewed as encouraging the yen's decline.