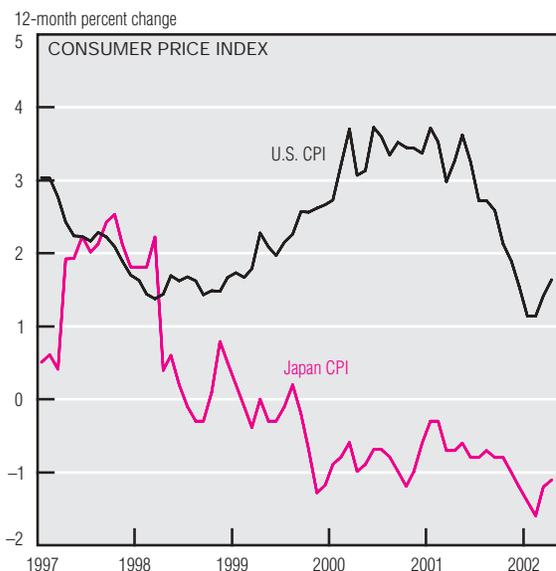
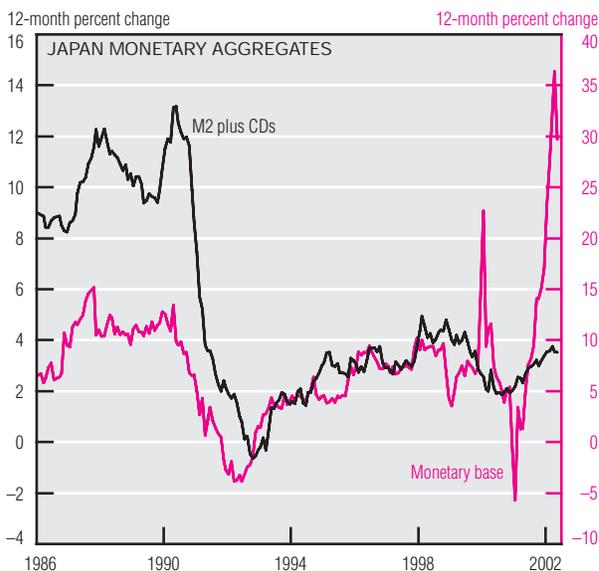
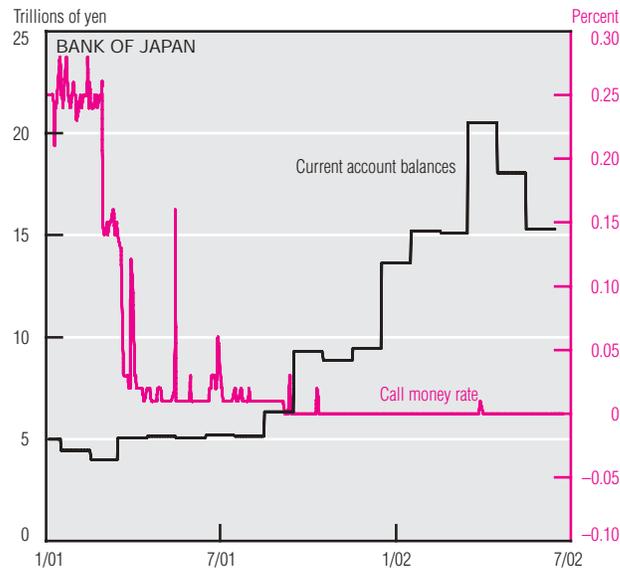
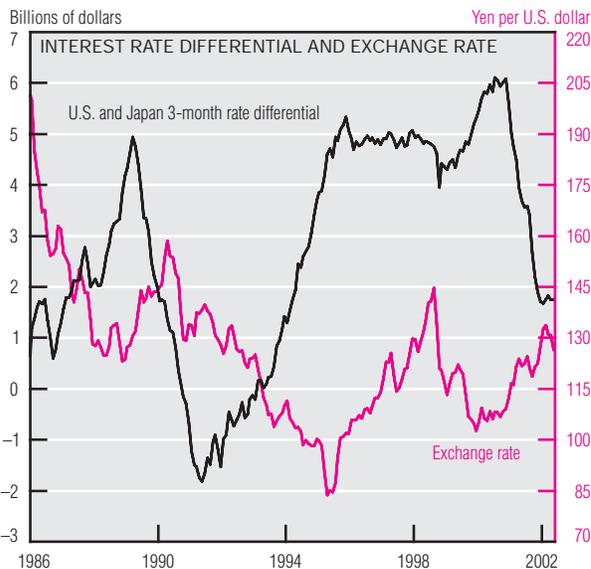


The Japanese Economy



SOURCES: Board of Governors of the Federal Reserve System; and Bank of Japan.

The dollar value of the yen has risen recently despite quantitative easing by the Bank of Japan. In addition, Japanese authorities intervened against the yen in late May and early June. Market observers, however, do not view these actions as particularly strong and speculate that stronger actions may be forthcoming if the yen continues to appreciate and damage Japanese exports.

One factor in the yen's strength against the dollar is the decline in U.S. short-term interest rates and other rates of return on investments in the U.S. The overall dollar sentiment

appears bearish to many analysts. Another factor is Japan's relatively positive first-quarter GDP numbers; however, it is unclear whether the Japanese economy will continue to rebound.

Quantitative easing by the Bank of Japan appears to be best measured by current account balances held at the Bank, which comprise bank reserves and deposits of nonbanks. These balances have risen sharply since last fall, and the bellwether short-term interest rate, the call money rate, has bottomed out. However, M2 plus CDs—the monetary

aggregate most closely related to economic activity—has risen little despite the rise in the monetary base. This implies that quantitative easing has not influenced spending.

Quantitative easing could depreciate the yen if it leads to higher Japanese inflation through purchasing-power parity, whereby Japanese products could remain competitive internationally only if the yen's international value fell. However, continued deflation and the weakness in M2 plus CDs reduce the likelihood of this occurring in the near term.