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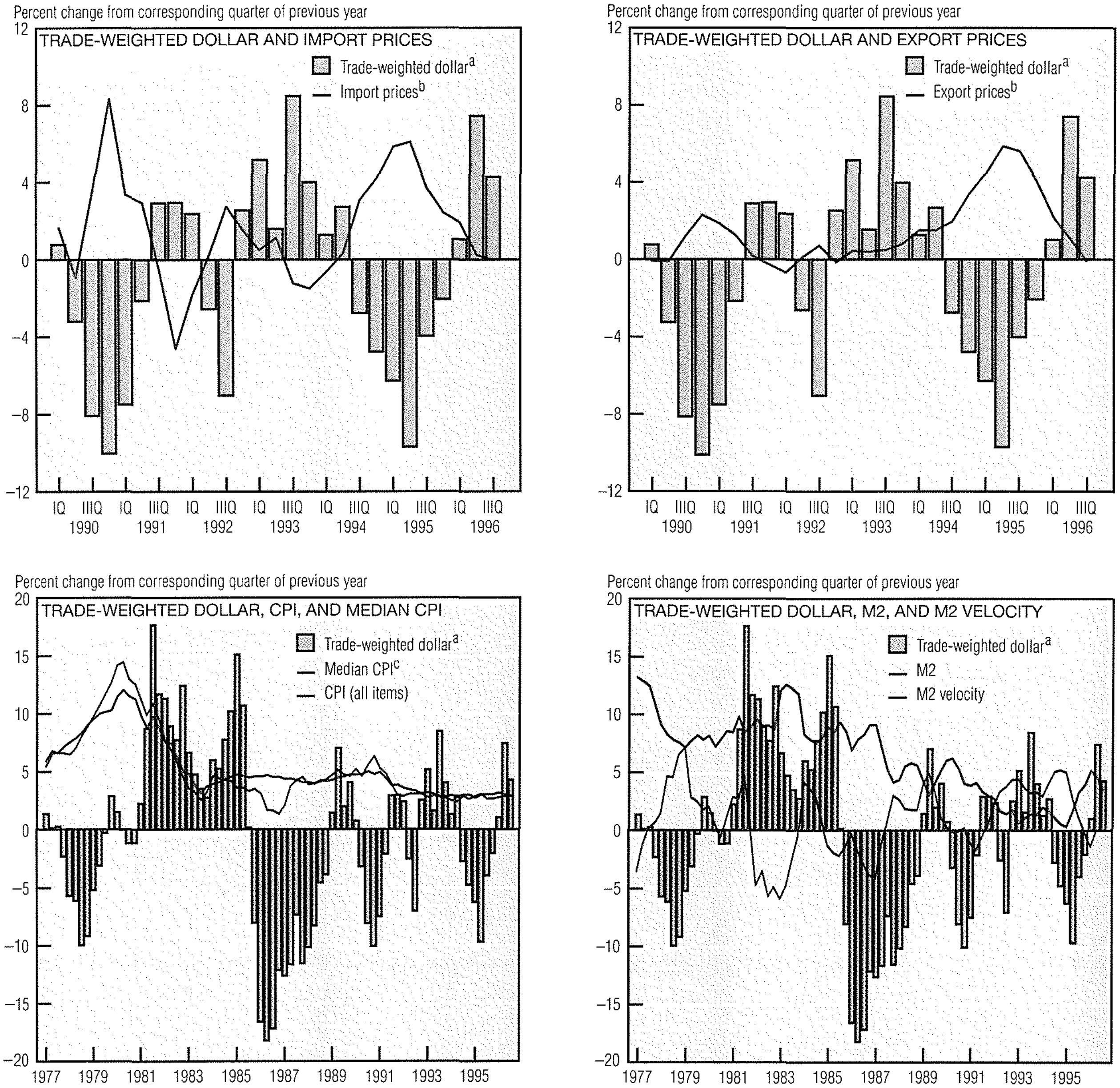
Exchange Rates and Inflation



a. Index, 1980=100.
b. Index, 1990=1.0.
c. Calculated by the Federal Reserve Bank of Cleveland.
SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; Board of Governors of the Federal Reserve System; the Federal Reserve Bank of Cleveland; and Citibank.

When the dollar depreciates in the foreign exchange market, Americans must pay more for foreign goods. Although the price effects of exchange-rate changes can ripple through standard price indexes, under no circumstances can a dollar depreciation cause inflation.

Exchange rates never move on their own; rather, they respond as other economic events change the supply and demand for dollars. If the dollar depreciates because the Federal Reserve increases the money supply excessively, then the monetary expansion, not the accompanying dollar depreciation, is the cause of inflation.

If the dollar depreciates because foreigners—for whatever reason—buy fewer American exports, the price of U.S. imports will eventually rise. The increase in import prices, however, can be sustained only if some other prices fall, the money supply increases, or the velocity of money rises. The first condition is not inflationary and will only affect those aggregate price indexes that weight import prices more heavily than the prices that fall. The second condition is also unlikely. If anything, the central bank will react to an unwanted depreciation by tightening—not easing—monetary policy. Finally, if higher domestic interest rates accompany a depreciation, velocity might rise. Evidence of such an effect is lacking, however.

Inflation is a decline in the purchasing power of money that manifests itself in higher prices. Higher prices are not always evidence of inflation.