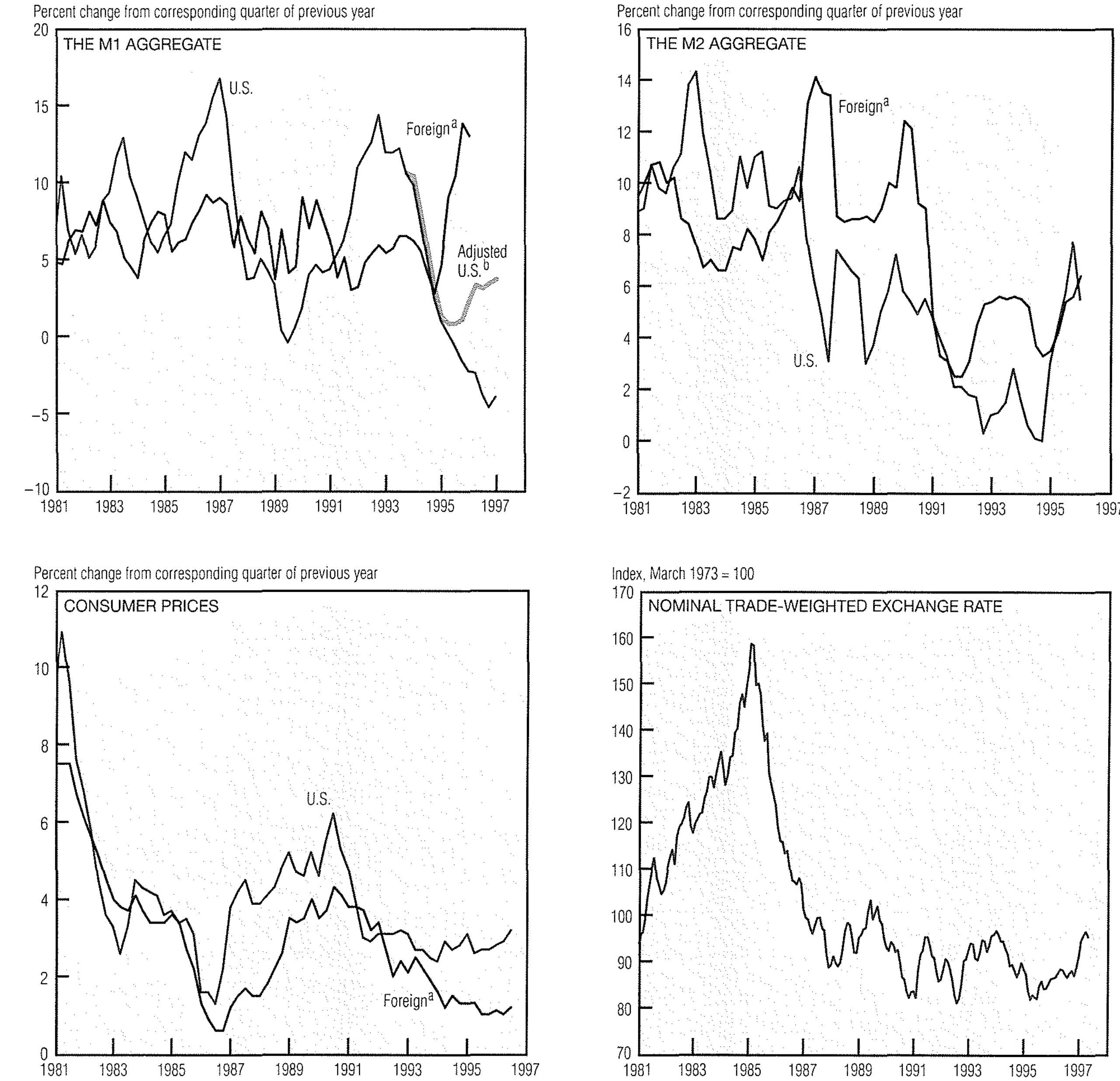
Money, Inflation, and Exchange Rates



a. Trade-weighted average.
b. Quarterly average of monthly data, adjusted for sweep accounts.
SOURCES: Board of Governors of the Federal Reserve System; and International Monetary Fund, *International Financial Statistics*.

Money, inflation, and exchange rates are all linked, but the connections are relatively complicated. Inflation occurs when a nation's central bank attempts to supply a greater quantity of money than the public desires to hold. Rising prices help balance the amount of money demanded and supplied.

Conventional money measures like M1 and M2 show only the stock of money that results from this equilibrating process. Consequently, the near-term connection between small fluctuations in money measures and prices depends on whether the observed changes in the money stock reflect growth in money demand holding supply fixed, or an expansion of the money supply holding demand fixed.

A country that creates an excessive amount of money will experience inflation, but how its exchange rate responds depends on the inflation rates of other nations. Countries with relatively high inflation rates experience currency depreciations. Hence, the effect of a nation's money creation on its exchange rate depends on both money demand at home and the relative growth of money supply and demand abroad.

All of these factors help explain why economists have trouble developing simple monetary models of exchange rates. Generally, these models perform worse than a simple projection of today's exchange rate.