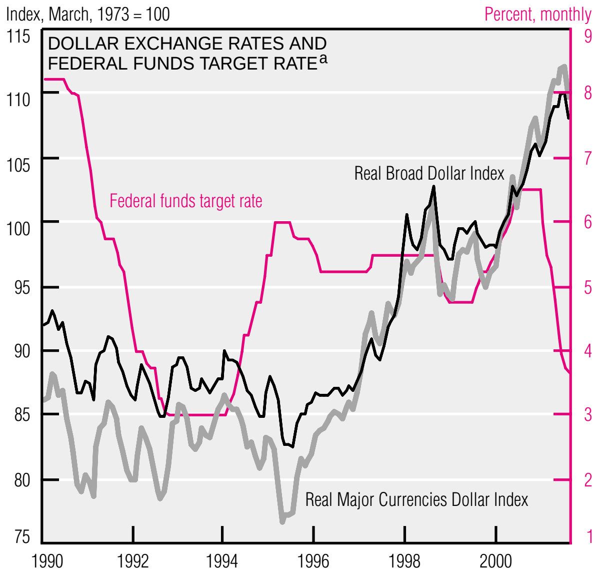
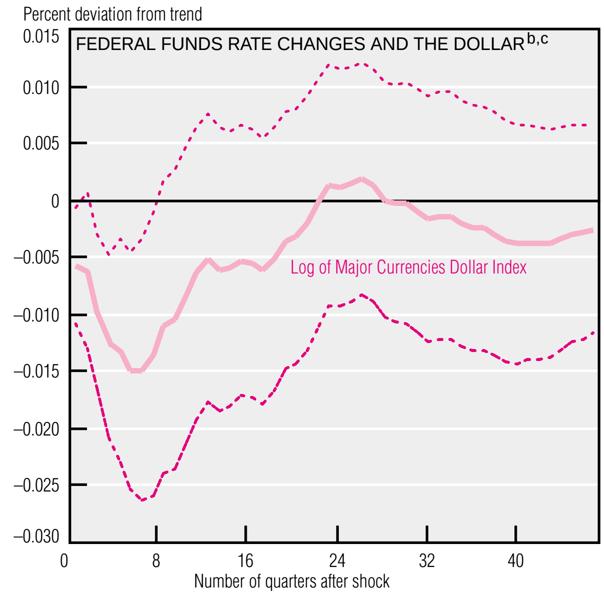
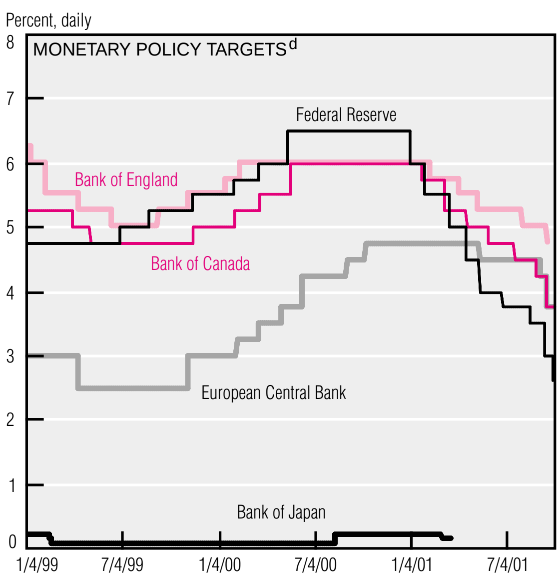
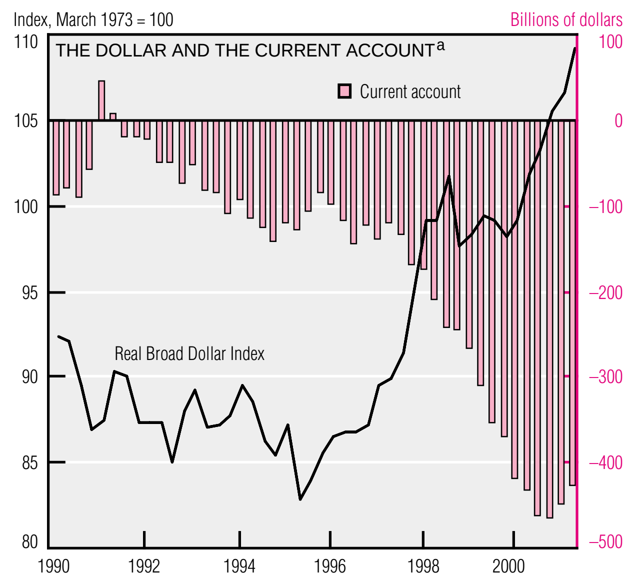
Exchange Rates and Monetary Policy









a. Increases (decreases) in the Real Broad Dollar Index and the Real Major Currencies Dollar Index measure average real appreciation (depreciation) of the dollar against the currencies of the 31 and 16 most important U.S. trading partners, respectively. Real indexes profile changing competitiveness by incorporating domestic and foreign price movements.

b. Estimated average effect of a one-standard-deviation change in the ex ante real federal funds rate on the logarithm of the Real Major Currencies Dollar Index between 1983:IQ and 2001:IQ.

c. Dashed lines show two standard deviations from trend.

d. Federal Reserve and Bank of Japan: overnight interbank rates (since March 19, 2001, the Bank of Japan has targeted a quantity of current account balances expected to be consistent with a zero overnight rate). Bank of England and European Central Bank: two-week repo rate.

SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; Board of Governors of the Federal Reserve System; Bank of Japan; European Central Bank; Bank of Canada; Bank of England; and Wholesale Markets Brokers Association.

Changes in the federal funds target rate affect economic activity through different channels or transmission mechanisms. Most people understand the interest rate transmission mechanism: Easier monetary policy encourages interest-sensitive spending by lowering short-term interest rates. Exchange rates offer another policy conduit.

If a decrease in the federal funds target lowers U.S. interest rates relative to those abroad, capital will flow out of the U.S., depreciating the dollar. That depreciation, however, lowers the foreign currency price of U.S. exports and raises the dollar price of imports, encouraging economic activity within our trade sector. Net exports and GDP rise.

The impact seems to last about eight quarters. As inflation accelerates, the competitive advantage that the dollar's depreciation conferred on the trade sector vanishes.

Despite allegations of its growing importance, the exchange rate transmission mechanism appears to have been nullified during the past year. Other central banks have eased their monetary policy along with the U.S., offsetting the effect of policy on exchange rates. Despite the lull in U.S. economic activity, foreign investors still seem to consider the U.S. an attractive place for long-term investment.