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.