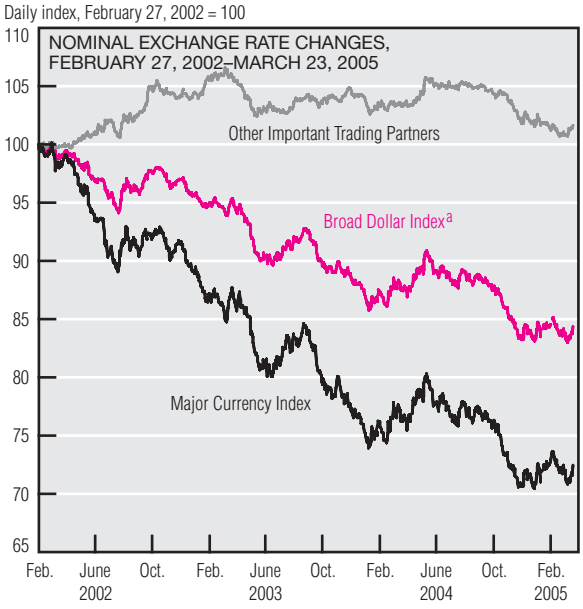
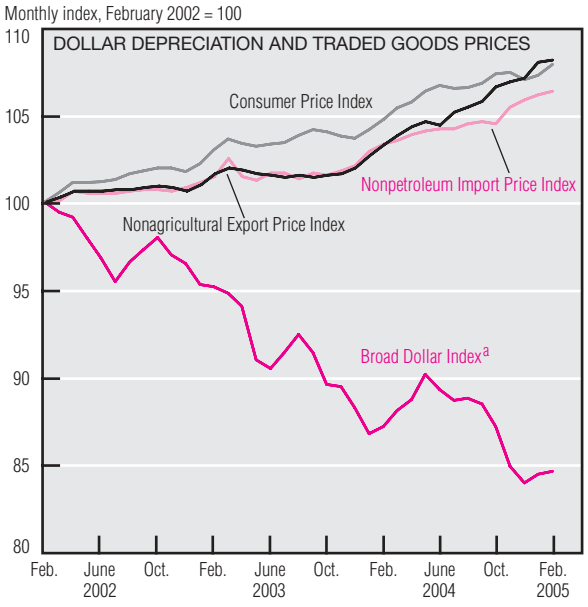
Dollar Depreciation and Inflation





Import Price Changes since the Dollar's Peak

	Percent change, February 2002–February 2005
Import Prices	
All commodities	15.2
Food, feed, and beverages	20.5
Industrial supplies and materials	64.3
Capital goods	–3.0
Automotive vehicles and parts	3.1
Consumer goods less autos	1.3
Petroleum and petroleum products	125.4
Nonpetroleum imports	6.4
CPI	7.9
Broad Dollar Index[a]	–15.4

Export Price Changes since the Dollar's Peak

	Percent change, February 2002–February 2005
Export Prices	
All commodities	8.6
Food, feed, and beverages	17.2
Industrial supplies and materials	31.8
Capital goods	–0.6
Automotive vehicles and parts	2.4
Consumer goods less autos	2.6
Agricultural commodities	17.0
Nonagricultural commodities	8.1
CPI	7.9
Broad Dollar Index[a]	–15.4

a. The Broad Dollar Index measures dollar movements against the currencies of our 26 most important trading partners. The Other Important Trading Partner Index measures dollar movements against 19 emerging market currencies. The Major Currency Index measures dollar movements against developed countries. All indexes are constructed on a trade-weighted basis.

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; and Board of Governors of the Federal Reserve System, "Foreign Exchange Rates," *Federal Reserve Statistical Releases*, H.10.

Since its peak in February 2002, the U.S. dollar has depreciated nearly 16% on average against the currencies of our most important trading partners, with surprisingly little impact on the prices of most traded goods. Oil accounts for most of the change in import prices.

All else constant, we might expect the *dollar price* of foreign goods to rise, and the *foreign-currency price* of U.S. goods to fall by the full percentage amount of the dollar's depreciation. Together, these price changes would shift worldwide demand away from foreign goods and toward U.S. products, eventually causing the *dollar prices* of all traded goods in the U.S.—imports and exports—to rise.

The timing and extent of these effects, however, depends heavily on the pricing strategies of large multinational firms, which can often adjust their profit margins to influence the pass-through of exchange rate changes into final product prices. Over the past 30 years, import prices have taken as long as three years to reflect exchange rate changes fully, and recent research suggests the pace is slowing. At most, export prices seem to incorporate only about three-quarters of the effect after three years.

The dollar's depreciation need not generate inflation; that depends on U.S. monetary policy. Since last June, the Federal Open Market Committee has been increasing the federal funds target rate to forestall inflationary pressures. If monetary accommodation is not excessive, the consumer price indexes need not echo—even faintly—the rise in traded goods prices.