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THE OUTLOOK

The Weak Dollar Isn't the Inflation Driver It Once Was

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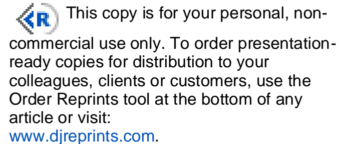

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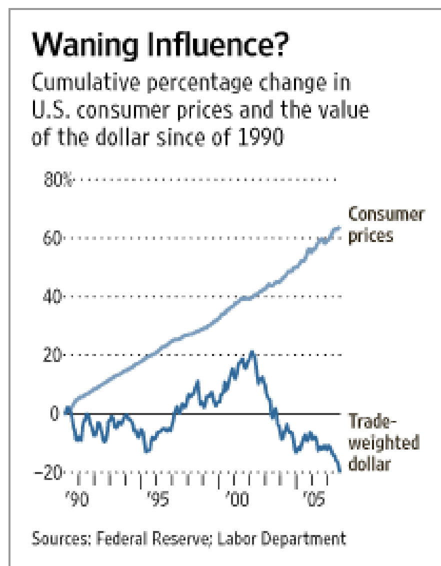
The plunging dollar has sent inflation alarm bells clanging across the U.S. But they may be false alarms.

A battery of research has been building over the years that the dollar doesn't drive U.S. inflation like it used to.

A key reason: Foreign exporters are so keen to keep U.S. market share that when the dollar weakens, they often lower their prices to keep them constant after the currency effect. That's especially true when the economy is slowing and consumers are less willing to pay higher prices.



A 10% decline in the value of the dollar -- the drop seen over the last year -- might be expected to raise the price of imports by 10%. But the actual pass-through is a fraction of that. Studies have found that only one-quarter to one-tenth of a currency depreciation gets passed through as higher prices for imported products.

That makes the U.S. Federal Reserve's job a bit easier during uncertain times. If the economy slows sharply, the Fed can lower interest rates -- a move that tends to weaken the dollar even more -- to boost the economy without worrying as much about inflation. Last month, Fed Chairman Ben Bernanke said that while a dollar depreciation leads to "some inflationary effect" as imports' costs rise, "our experience over the recent decade has been that those effects are relatively small."

The Fed's job is to balance growth and inflation, and few economists believe the central bank should act simply to preserve the dollar's value. Moreover, for Fed policy makers, the weak dollar has been a timely benefit: It is boosting U.S. exports, which helps ease the pain of a severe housing downturn and credit crunch.

"Right now, they're going to view this as good, not bad," said Brandeis University professor Stephen Cecchetti. "There are no tangible inflation risks that are coming out of it."

Markets seem to agree. The dollar's five-year decline hasn't raised inflation expectations, as expressed by the bond market. Prices of gold, oil and other commodities have surged, but much of the cause has been growing demand and speculation in financial markets.

A recent study by Fed staffers found that the U.S. consumer got special treatment from companies sending goods into the country -- they have been more willing to accept thinner margins, especially since 2002. They didn't give as much latitude to other countries, reflecting the dollar's international dominance and concerns about losing ground in a key market.

Even if the weak dollar has only a modest impact on inflation, there are other risks. Core inflation, which excludes food and energy, has remained tame in recent months, within the 1%-to-2% comfort zone for some Fed officials. But the dollar's decline could boost the public's expectation of future inflation, creating a self-fulfilling effect that pushes prices higher.

The dollar decline can create a communications problem for Fed officials, whose policy decisions aren't directed toward the dollar but may nevertheless depress the currency. "It sets the market backdrop which your policy actions will be interpreted against," said Vincent Reinhart, a resident scholar at the American Enterprise Institute and former head of the Fed's monetary-affairs division. "People might get confused as to why exactly you're easing policy."

The declining dollar used to have a bigger impact on import prices. From the mid-1970s through the 1990s, the pass-through rate was as high as 50% -- meaning a 10% drop in the dollar would raise import prices by 5%. This decade the pass-through rate has been less than 25%. For the overall economy, that's still a small increase because imports are a fraction of the goods consumed.

Of the roughly $2 trillion of goods imported by the U.S. last year, more than one-third came from Asia. Compared with the euro, Asian currencies have remained far more stable against the dollar, partly because some countries, such as China, manage their currencies to hold down their value.

In addition, in many cases, importers' costs for cheaper goods from China are just a fraction of the ultimate prices charged U.S. consumers, due to markups. The companies bringing goods into the U.S. have the choice of "eating it in their margin or jacking up their price when the exchange rate moves," Mr. Cecchetti at Brandeis said.

How a falling dollar affects imports can depend on the specific product: The prices of some luxury imports, such as BMW vehicles, have stayed steady as manufacturers accept lower profits. Airlines, however, operate on thinner margins and are quicker to raise ticket prices if their costs rise.

In addition, price increases in raw materials, including steel and other commodities, tend to pass through at much higher rates -- 90% or more -- in part because they are priced globally and hit firms equally.

Some economists question how long companies will accept weaker profits. "If oil continues on its path...we're going to see more pass-through from oil than we've seen before, says Joel Popkin, an economist who analyzes price trends for his own company. "You're starting to get to the point where the costs can't be absorbed."

Other economists are keeping a sharp eye out for dollar-induced inflation, even as they note that their economic models suggest little reason to worry. "We're not blind to the risk that something may have changed," said Lehman Brothers economist Drew Matus. "You can never really tell the regime shifts until it's too late."

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