Most of us do not pay attention to exchange rates until we start planning an international trip. When traveling, changes in the exchange rate become important to us because they influence the cost of our trip. Over the last few summers, I have seen the exchange rates of U.S. dollars for Euros fluctuate widely between $1.05 and $1.31. The last time I checked, a Euro cost $1.17, which is right in the middle of this range.

When a Euro only cost $1.05, international travel became cheap for Americans. It will cost Americans $1,050 to obtain a 1,000 euros. In contrast, when the euro cost $1.31, to obtain 1,000 euros, Americans had to spend $1,310. The difference is $260 per 1,000 euros spent. A family taking a trip where they spend 5,000 Euros will see a cost difference of $1,300 that depends just on these exchange rates. This is enough money that even Nancy Pelosi would not consider the cost difference to be just crumbs.

Anyone planning a trip to a country in the Eurozone in 2019 will be interested in how the exchange rates will change over the course of the next year. However, I will not make a prediction of next year's exchange rate. Instead, I will explain what will happen to the exchange rate if the U.S. experiences inflation and Europe does not. I picked this consideration because our central bank is very worried about U.S. inflation, so it is a likely outcome. In addition, I picked inflation as a consideration because its influence on exchange rates is far from obvious.

As a starting point, let us assume the exchange rate is $1.17 a Euro. If the U.S. experiences inflation, the prices of most goods and services in the U.S. will increase. To avoid these higher prices, Americans will want to buy more euros, because the European prices, by remaining stable, have become relatively cheaper than the now more expensive American goods. In order to get the extra Euros that they want, Americans will have to pay more in dollars to convince the Europeans to exchange additional Euros for dollars. Due to this dynamic, the exchange rate may increase to $1.25 per Euro.

At the same time, Europeans will see the high U.S. prices and want to buy fewer U.S. goods at any exchange rate. With fewer euros available, Americans will have to pay Europeans even more dollars in order to convince them to part with their Euros. The net effect of Americans wanting more euros and Europeans wanting fewer dollars will be a more expensive euro. After these two effects have taken place, a euro may again cost $1.31.

Of course, if the Eurozone has higher inflation than the U.S., then the dollar will become more valuable relative to the Euro. With high European inflation, it may only cost $1.05 or less to buy a Euro.

Predicting exchange rates is tough to do, and like everyone else, economists do not do it well. Our problem is that it is impossible to know what events will influence this market. However, once economists know the relevant events and circumstances, then we are very good at predicting the influence of these events on the exchange rates. For those people who are going to travel internationally next year, keep an eye on the inflation rates. If the inflation rates change between now and when you take your trip, this column can serve to give you some insight into how the exchange rates will change.

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