PAGE ONE Economics®
the back story on front page economics
NEWSLETTER

March ■ 2015

Is a Strong Dollar Better than a Weak Dollar?

Scott A. Wolla, *Senior Economic Education Specialist*

"Our exchange rate is just a price—the price of the dollar in terms of other currencies. It is not controlled by anyone. And a high price for the dollar, which is what we mean by a strong dollar, is not always desirable."

—Christina Romer[1]

All words have connotations; they suggest certain meanings. For example, "strong" and "weak" are usually considered opposites, so one might think that it's always better to be strong than to be weak. However, in referring to the value of a country's currency, it's not that easy. "Strong" is not always better, and "weak" is not always worse. The terms "stronger" and "weaker" are used to compare the value of a specific currency (such as the U.S. dollar) relative to another currency (such as the euro). A currency appreciates in value, or strengthens, when it can buy more foreign currency than previously. You can likely think of several advantages of being able to buy more foreign currency, but just because a country's currency is stronger does not mean that everyone in that country is better off. A currency depreciates in value, or weakens, when it can buy less of a foreign currency than previously. Similarly, just because a country's currency has weakened does not mean that everyone in the country is worse off (see the boxed insert). As the figure shows, the U.S. dollar has been appreciating lately relative to other currencies.

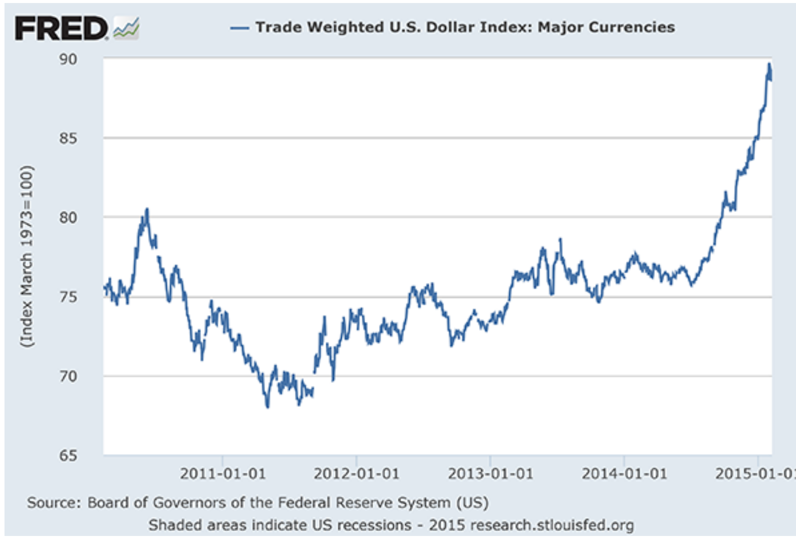
Supply and Demand in the Foreign Exchange Market

When a German carmaker sells cars to American consumers, the consumers pay for the cars in U.S. dollars, but the German carmaker cares about how much it receives in euros, the official currency of the euro zone, which includes Germany. The German carmaker must use euros to pay its suppliers, employees, and shareholders. When an American buys a German car, the American pays in dollars, which the German carmaker uses to buy euros in the **foreign exchange market** (or FX market).

The FX market functions like other markets—there is a supply, a demand, and a market price. The supply consists of the currency being sold in the market, and demand is created as buyers purchase

Comparing Currencies

The words "relative to" are used several times throughout this essay to show the comparative relationship between two currencies. For example, assume one unit of currency A buys one unit of currency B. Then, one month later, one unit of currency A buys two units of currency B. In this case, currency A has appreciated, or strengthened, relative to currency B. On the other side of this transaction, while one unit of currency B used to buy one unit of currency A, it now takes two units of B to buy one unit of A—currency B has depreciated relative to currency A. So, there are two sides of the same transaction: If currency A is appreciating relative to currency B, then currency B is depreciating relative to currency A.



NOTE: Appreciation of the U.S. dollar relative to other major currencies.

SOURCE: FRED®, Federal Reserve Economic Data, Federal Reserve Bank of St. Louis: Trade Weighted U.S. Dollar Index: Major Currencies [DTWEXM]; Board of Governors of the Federal Reserve System; https://research.stlouisfed.org/fred2/series/DTWEXM/; accessed January 29, 2015.

the currency in the market. And, as in other markets, as the forces of supply and demand shift, the price of currency in the FX market changes. In this case, the price is the **exchange rate**, which is the price of one country's currency in terms of another country's currency. When consumers and firms demand more U.S. dollars than previously, the increased demand for U.S. dollars will increase (or strengthen) its value in terms of euros. The increase in the supply of the euros that consumers and firms bring to the market will decrease (or weaken) its value relative to the U.S. dollar.

Who Benefits and Who Is Hurt by Changing Currency Values?

Imagine you want to buy a German car here in the United States. The German carmaker must calculate the price to charge, based on its cost of production plus a markup. The carmaker pays *these* costs in euros (Germany's currency) and so cares about the price of the car in euros. Let's say that cost is 17,000 euros. American consumers, of course, care only about the price they pay in U.S. dollars, so the carmaker must set the price in U.S. dollars. Given a dollar-to-euro exchange rate of 0.7, the dollar price of the car would be $24,285.

Now imagine the dollar strengthens and the dollar-to-euro exchange rate increases to 0.8. (That is, instead of "buying" 0.7 euros with a dollar, you can now buy 0.8 euros with the same dollar.) At this point, the carmaker has a couple of options: It can keep the car's dollar price at $24,285, which would bring in 19,428 euros (up from 17,000), allowing the firm to earn higher profits. Or the German carmaker could hold the euro price at 17,000 euros and lower the price in U.S. dollars, which would decrease from $24,285 to $21,250, allowing the German carmaker to compete for U.S. customers at a lower dollar price without lowering its euro price. Or, it can make a little more money on each car while reducing the price to increase market share. In short, if the U.S. dollar strengthens relative to the euro, the German carmaker can either (i) keep the dollar price the same and earn a higher profit in euros or (ii) sell its cars at a lower dollar price, thereby gaining more U.S. customers. A price cut benefits the German carmaker and U.S. consumers, but it is bad for U.S. automakers that must compete with these lower prices.

It's important to realize that as the U.S. dollar strengthens relative to the euro, the euro weakens relative to the U.S. dollar. As a result, goods and services produced in the United States become relatively more expensive for foreign buyers, which hurts U.S. (**domestic**) producers that export goods. In short, a stronger U.S. dollar means that Americans can buy foreign goods more cheaply than before, but foreigners will find U.S. goods more expensive than before. This scenario will tend to increase imports, reduce exports, and make it more difficult for U.S. firms to compete on price.

So, who benefits and who is hurt by a weak dollar? A weaker U.S. dollar buys less foreign currency than it did previously. This makes goods and services (and assets) produced in foreign countries relatively more expensive for U.S. consumers, which means that U.S. producers that compete with imports will likely sell more goods (such as American cars) to U.S. consumers. A weaker dollar also makes U.S. goods and services (and assets) relatively less expensive for foreign buyers, which benefits U.S. producers that export goods. In short, a weaker dollar means that Americans will find foreign goods to be relatively more expensive than before, but foreign consumers will find U.S. goods less expensive than before. This scenario will tend to increase exports, reduce imports, and make goods and services produced by U.S. firms more attractive to American consumers.

Conclusion

The implications of words such as "strong" and "weak" can mislead people to believe that an appreciating currency is always better for the economy than a depreciating currency, but this is not the case. In fact, there is no simple connection between the strength of a country's currency and the strength of its economy. However, the value of the dollar relative to other currencies does affect individuals differently. Other things equal, a stronger dollar makes U.S. goods relatively more expensive for foreigners, which benefits U.S. consumers of foreign goods (imports) and hurts American exporters and American firms that might not export but do compete with imports. In addition, a weaker dollar makes foreign goods (imports) relatively more expensive for American consumers, which benefits exporters of U.S. goods and American firms that compete with imports. ■

NOTE

[1] Romer, Christina. "Needed: Plain Talk About the Dollar." *New York Times*, May 21, 2011; http://www.nytimes.com/2011/05/22/business/economy/22view.html?pagewanted=all&_r=0.

GLOSSARY

Domestic: Inside a particular country.

Exchange rate: The price of one country's currency in terms of another country's currency.

Foreign exchange market: A market in which one country's currency can be used to purchase another country's currency.

Page One Economics Newsletter from the Federal Reserve Bank of St. Louis provides an informative, accessible economic essay written by our economic education specialists, who also write the accompanying classroom edition and lesson plan. The newsletter and lesson plans are published 5 times per year: January, March, May, September, and November.

Please visit our website and archives http://research.stlouisfed.org/pageone-economics/ for more information and resources.