Is a Strong Dollar Better than a Weak Dollar?
March 2015

An informative and accessible economic essay with a classroom application.

Includes the full version of the Page One Economics Newsletter, plus questions for students and an answer key for classroom use.

Common Core State Standards (see page 10)

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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. 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
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


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.
“Is a Strong Dollar Better than a Weak Dollar?”

After reading the article, answer the following questions.

1. What does it mean for a currency to appreciate, or become stronger?

2. What does it mean for a currency to depreciate, or weaken?

3. For each of the following scenarios, imagine that the U.S. dollar has become either stronger or weaker since an earlier period. For each category, identify how a stronger or weaker dollar affects (i) U.S. producers that sell to foreign consumers (exporters), (ii) U.S. producers that compete with imports, and (iii) American consumers of foreign goods (imports).

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<thead>
<tr>
<th>Scenario</th>
<th>Who benefits?</th>
<th>Who is hurt?</th>
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<td>Stronger dollar</td>
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<tr>
<td>Weaker dollar</td>
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4. Markets have a supply, a demand, and an equilibrium price. Identify each of these for the foreign exchange market:
   - Supply:
   - Demand:
   - Price:
After reading the article, answer the following questions.

1. What does it mean for a currency to appreciate, or become stronger?
   A currency appreciates in value, or strengthens, when it buys more foreign currency than previously.

2. What does it mean for a currency to depreciate, or weaken?
   A currency depreciates in value, or weakens, when it buys less of a foreign currency than previously.

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| Stronger dollar| American consumers of foreign goods (imports) | U.S. producers that sell to foreign consumers (exporters)  
|                |                                        | U.S. producers that compete with imports |
| Weaker dollar  | U.S. producers that sell to foreign consumers (exporters) | American consumers of foreign goods (imports) |
|                | U.S. producers that compete with imports |                                                |

4. Markets have a supply, a demand, and an equilibrium price. Identify each of these for the foreign exchange market:
   Supply: The currency being sold in the foreign exchange market
   Demand: The currency being purchased in the foreign exchange market
   Price: The exchange rate, which is the price of one country’s currency in terms of another country’s currency
For Further Discussion

Review the following or distribute the handout to your students; then lead a classroom discussion on changes in the relative value of currencies.

For each of the following scenarios, determine whether you would prefer for the dollar to appreciate or depreciate relative to the euro.

1. You are planning a trip to Italy.
   
   You would prefer the dollar to appreciate against the euro.

2. You are a U.S. businessperson whose chief competitor is a French firm.
   
   You would prefer the dollar to depreciate against the euro.

3. Your job depends on European tourists visiting the United States.
   
   You would prefer the dollar to depreciate against the euro.

4. Your factory relies on parts imported from Germany.
   
   You would prefer the dollar to appreciate against the euro.

Assume the U.S. dollar has strengthened relative to the euro. Identify whether the underlined person benefits or is hurt as a result of the change.

5. A French tourist plans to visit New York City.
   
   The French tourist is hurt by the stronger U.S. dollar.

6. An American tourist plans to visit Paris.
   
   The American tourist benefits from the stronger U.S. dollar.

7. An American car producer competes with German cars.
   
   The American car producer is hurt by the stronger U.S. dollar.

8. A German car producer competes with American cars.
   
   The German car producer benefits from the stronger U.S. dollar.

9. A German firm is investing in U.S.-produced machinery.
   
   The German firm is hurt by the stronger U.S. dollar.

10. An American firm is investing in German-made machinery.
    
    The American firm benefits from the stronger U.S. dollar.
The figure shows the exchange value of one U.S. dollar relative to Canadian dollars. For example, the most recent data on the graph show that at the end of 2014, one U.S. dollar could be used to purchase 1.1 Canadian dollars. For each of the following periods, indicate whether the U.S. dollar appreciated or depreciated relative to the Canadian dollar.

11. From 1977 to 1986 the U.S dollar appreciated relative to the Canadian dollar.
12. From 1987 to 1991 the U.S dollar depreciated relative to the Canadian dollar.
13. From 1992 to 2002 the U.S dollar appreciated relative to the Canadian dollar.
14. From 2003 to 2008 the U.S dollar depreciated relative to the Canadian dollar.
15. In 2009 the U.S dollar appreciated relative to the Canadian dollar.
16. From 2010 to 2011 the U.S dollar depreciated relative to the Canadian dollar.
17. From 2012 to 2014 the U.S dollar appreciated relative to the Canadian dollar.

Additional Teaching Resource: Currency Crusaders Online Course for Teachers and Students

In Currency Crusaders of Justice, Jack of All Trades and his best bud, Andy, are traveling the world by cape, having a coffee at each stop. Andy learns that purchasing those coffees using the currencies of their host countries presents a minor complication—the relative value of currencies around the world can change and make those coffees more expensive or less expensive. How does that happen? Stay tuned and you'll learn how economic conditions affect exchange rates…and the price of coffee everywhere. Read more at https://www.stlouisfed.org/education/currency-crusaders-online-course-for-teachers-and-students.

To register your students for one or more of these courses, visit the Instructor Management Panel at https://bts.stlouisfed.org/bts/econ_ed/online_learning/.
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Common Core State Standards
Grades 6-12 Literacy in History/Social Studies and Technical Subjects

- **Key Ideas and Details**
  RH.11-12.1: Cite specific textual evidence to support analysis of primary and secondary sources, connecting insights gained from specific details to an understanding of the text as a whole.
  RH.11-12.2: Determine the central ideas or information of a primary or secondary source; provide an accurate summary that makes clear the relationships among the key details and ideas.

- **Craft and Structure**
  RH.11-12.4: Determine the meaning of words and phrases as they are used in a text, including analyzing how an author uses and refines the meaning of a key term over the course of a text (e.g., how Madison defines *faction* in *Federalist* No. 10).