

The Incredible Shrinking Dollar

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Many of us have heard that the “dollar is falling” or that the “dollar is weak”. But what does this mean? Why is the dollar falling? When will it stop? What will happen if it continues?

Let's first discuss what people mean when they say the dollar is “weak” or “falling”. By definition, *the “strength” of the currency is relative to the values of other currencies*. Let me explain. Let's say right now the dollar trades equal to the British currency, the pound (GBP). 1 dollar equals 1 pound, so an item that costs 3 pounds can be purchased for 3 dollars. If the exchange rate changes so that 1 dollar buys 1 1/2 pounds, the dollar is “rising” and getting “stronger” against the pound. In this scenario, an item that costs 3 pounds can be purchased for 2 dollars. On the other hand, let's say the rate changes so that 1 dollar only buys 1/2 a pound. In this scenario, then the dollar is “falling” and is now “weaker” against the pound. An item that costs 3 pounds will cost us 6 dollars.

In general, in recent years the dollar has been falling against other currencies. So, many are saying that the dollar is now weak. But it is important to note that everybody does not agree that the dollar is weak. Our current administration believes that while the dollar has been falling, it was not at a fair level to begin with. They feel that the value was too high. The administration points to the trade imbalance as proof. In their view, the dollar has been falling back to what they consider a normal level and the weakening of the dollar, they believe, may be healthy for the economy.

How can a weaker dollar be good? A falling dollar has many advantages. It makes US goods less expensive overseas and foreign goods more expensive at home. In other words, it encourages sales of US goods and services both abroad and in the US. Higher sales create better earnings for US companies. It also makes foreign labor more expensive which may mean more US jobs. Finally, if US sales are higher and prices of goods rise, it will result in more tax revenue for the government. And many people view this as the cause of the downward pressure on the dollar. Namely, that the current US budget deficit is simply too large to sustain.

To many of us, this scenario sounds appealing. How can more sales of domestic products, higher earnings, competitive pricing with foreign goods, more tax

revenue, and shrinking trade and budget deficits be bad? The answer is that while a weaker dollar may be beneficial if moderately applied, a continued drop or a long-term weakness can have the opposite effect.

Perhaps the major drawback to the weakening of the dollar is that it creates inflationary pressures. Commodities, which are priced on the global market, become relatively more expensive. Thus the raw materials we use to produce our goods will likely cost more, resulting in higher prices of goods. Furthermore, since we buy so many foreign goods, the price of items such as fruits, vegetables, and other staple goods will likely rise. But while the higher cost of foreign goods makes US items comparatively more inexpensive, domestic producers have been under such pressure to keep margins low, they may now simply choose to increase their own prices as foreign prices rise.

Second, a falling dollar makes investing in US securities less attractive. By simply holding goods in US dollars, the value will decrease as the dollar weakens. This means less financing of debt, such as government bonds, unless interest rates rise. Therefore, as the dollar weakens, the government must raise interest rates on government securities to continue to attract investors. This means the government must pay more on borrowed money. It also results in higher interest rates on other items, such as home loans and credit card bills. To see how this affects the stock markets we can look to 1987 when Secretary Baker declared a US policy to allow its currency to fall 35%. The resulting pull out of foreign capital was a major factor in the stock market collapse.

Finally, if the dollar weakens enough, it could create an unfair advantage to US firms resulting in less competition. Protectionist strategies in the past on automobiles, consumer electronics and other goods have generally had the undesirable effect of less innovation, slower reaction to consumer needs, and higher prices.

So, now we know that a weak dollar can stimulate the economy but that if the dollar falls too fast, if it falls for too long, or if it stays weak for a long period of time we, as consumers and investors, could be in for trouble. The administration must walk a very fine line. While some currency devaluation may help the economy and reduce pressure on the budget deficit, too much will result in higher inflation, loss of foreign capital, and reduced competition.

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