Is the U.S. Dollar Strong or Weak?

April 12, 2021

Many years ago, Tom would commute to NYC by train. Occasionally two trains would be stopped in the same train station. As he sat on one of those trains looking out the window at the other train, he had a weird feeling when one of the trains started to move. Initially, he could not tell whether the train he was on was moving or the other train was moving. Developing a story about the strength or weakness of the U.S. dollar on international currency markets can produce the same effect: Is the dollar getting stronger or are other currencies getting weaker?

For most Americans, neither of these two stories has any real meaning. Since Americans deal in transactions that involve the dollar, the relative value of our currency to other currencies does not make a lot of difference. Only under dire circumstances e.g., a substantial increase or decrease in the dollar's value would there be an impact worth discussing.

However, there are important aspects of the changing value of the dollar. For example, when the dollar gets strong, U.S. companies that have a substantial multinational dependence can see their earnings weaken when those foreign sales that are denominated in weaker foreign currencies are translated back into dollars. This translation is important to accurately portray profits and losses on the company's domestic balance sheet. On the other hand, the prices of imported goods should fall as the dollar can buy more of the foreign currencies that reflect the price of those imported goods. The bottom line is that a strong dollar or weak foreign currency usually translates into bad news for multinational companies as well as domestic U.S. companies that must compete against those imports. The good news is for American consumers who pay less for those foreign goods and have something left over to purchase more things. Of course, the opposite is true when the dollar is weak.

Another factor that can add volatility to global financial markets is if the dollar strengthens too much so that countries with substantial debts denominated in dollars find themselves in a deteriorating financial position because they must pay that debt in more expensive dollars. On the other hand, when the dollar is weak, countries borrow more dollars because they are cheaper.

Another critical factor in the conversation about the dollar is that it became the world's reserve currency after World War II. Due to its perceived medium of exchange and store of value characteristics, other countries rely on the dollar to conduct their international trade. OPEC required payment for their oil exports in dollars, giving the dollar an important responsibility in maintaining world trade. Once a currency loses the confidence of countries and companies, it becomes irrelevant on the world monetary stage. One good example of this was the fall in the value of the British pound that was the world's reserve currency in the 19th century and the first half of the 20th century.

At one time many currencies were tied to the value of gold. This relationship was known as a fixed exchange rate standard. Due to the inflexibility of maintaining good economic policy under a rigid currency regime such as this "hard" currency standard, countries abandoned such a fix or a standard. Today the world exists on a fiat currency system and there is nothing but the faith of the users of that currency to facilitate world trade. Given the strength of the U.S. economy in this post pandemic world, the value of the dollar should remain within a trading range, an important characteristic in maintaining a functioning world economy.