11.7: Strengthening vs. Weakening Currencies

We often hear on the news about the US dollar strengthening or weakening and this concept has been mentioned a few times above. However, what does it mean, what are the implications, and how do we know if the dollar is getting stronger or weaker? First, let us look at what we mean by strengthening and weakening. We can think of exchange rates as prices — the price of one currency relative to another. If the US dollar is getting stronger relative to another currency, that means that it costs more of the foreign currency to purchase one dollar (or one dollar can buy more of the other currency than it could previously). In other words, the price of the dollar has gone up. If the dollar is weakening, then the price of the dollar has gone down and it takes more dollars to purchase a specific amount of foreign currency. Let's look at two examples from the currency table above.

Example One – Indirect Quote

On October 1, 2020, the exchange rate was 0.8509 euros/$. A month prior (September 1, 2020), the exchange rate was 0.8370 euros/$. This means that on the starting month (September), one US dollar could buy 0.8370 euros. At the ending month (October), the same dollar could buy 0.8509 euros. Since each dollar buys more euros on Oct. 1st than it could on Sept. 1st, the US dollar has gotten stronger relative to the euro (or, alternatively, the euro has weakened relative to the dollar).

Example Two – Direct Quote

On October 1, 2020, the exchange rate was $1.1752/euro. A month prior (September 1, 2020), the exchange rate was $1.1947/euro. This means that on the starting month (September), a single euro could buy $1.1947. At the ending month (October), the same euro could buy $1.1752. Since each euro buys fewer dollars on Oct. 1st than it could on Sept. 1st, the euro has gotten weaker relative to the US dollar (or, alternatively, the US dollar has strengthened relative to the euro).

Note that the exchange rates used in example one and two are exactly the same, just presented in a different format. However, some students try to focus only on the number and not the meaning of the exchange rate and this can cause problems. In the first example, the number got larger (0.8370 ⇒ 0.8509) and in the second example, the number got smaller (1.1947 ⇒ 1.1752). However, in both cases the US dollar got stronger relative to the euro. **Be sure to think of what the numbers represent (dollars per foreign currency or units of foreign currency per dollar) and not just on whether the number got larger or smaller.**

One thing to keep in mind here is that currencies are a relative price. The price of the US dollar in yen (the yen/dollar exchange rate) is different from the price of the US dollar in euros (the euro/dollar exchange rate). Therefore, it is important when we talk about the US dollar getting stronger or weaker to be precise and say what currency it is stronger or weaker relative to. The US dollar may strengthen relative to the yen while weakening relative to the euro. Look at the month from May 1, 2020 to June 1, 2020. Each dollar bought fewer euros (0.8991 euros in June vs. 0.9093 euros in May). Meanwhile, each dollar bought more yen (107.5741 yen in June vs. 106.7809 yen in May). Therefore, during this time period, the dollar weakened relative to the euro (dollar buys fewer euros) and strengthened relative to the yen (dollar buys more yen).

Second, we need to look at the implications. Who benefits from a stronger US dollar? Who benefits from a weaker US dollar? Let's start with a disclaimer. The effects of changing exchange rates are often complex and impact a variety of economic factors (some of which feed back to the exchange rate itself). Therefore, think of these as the primary (or first-level) impacts.

- US-based consumers will typically benefit from a stronger US dollar. The stronger dollar means that it is now cheaper for US consumers to buy imported goods. This may also cause US firms to lower prices to stay competitive. A weaker US dollar will typically increase the costs of goods and services for US-based consumers.
- US-based firms will typically benefit from a weaker US dollar. A weaker dollar means that foreign firms will become less competitive. Also, exports will be cheaper to foreign customers (as each unit of foreign revenue buys more US dollars). A stronger US dollar will typically have a negative impact for US-based firms.
- Foreign-based firms will typically benefit from a stronger US dollar. The stronger dollar means that each dollar in revenues they receive in US markets translates into more revenues in their home currency.
- US-based investors in international markets will typically benefit from a weaker US dollar. Their investment returns in these foreign markets will need to be converted back into dollars. A weaker US dollar means each unit of foreign currency earned as investment income will buy more US dollars, increasing their return in US dollars.
- Foreign-based investors in US markets will typically benefit from a stronger US dollar. As the dollar strengthens, each dollar received in investment income will buy more of their home currency, which increases their rate of return in their home currency.

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