How a Weak Dollar Drains Your Pocketbook

By Sheyna Steiner | August 03, 2011

Fears about a weak dollar are beginning to reach a fever pitch, and some are worried. But are these worries justified?

The dollar's strength is judged against other currencies, and lately it has compared poorly against major rivals such as the Swiss franc, the Japanese yen, the Australian dollar and others.

When a dollar buys more than its equivalent in another currency, it's considered strong. When it buys less than its equivalent, it's weak. For instance, recently a dollar was worth 0.69 euro, and conversely a euro was worth $1.43 -- a great deal for, say, Germans, but not so good for Americans. That's because German consumers have more buying power in the global marketplace when the euro is strong.

Despite all the public hand-wringing on the issue, the actual exchange rate has little direct impact on individuals. For consumers, what matters more is the purchasing power of those dollars -- reflected by the Consumer Price Index.

While the exchange rate fluctuates in the short term based on recent events and forecasts, the longer-term trajectory is mainly dictated by monetary policy, which in turn affects inflation. In the U.S., for instance, the Federal Reserve uses interest rates and other measures to control inflation and stimulate economic growth. Countries that keep inflation in check and have a growing economy are seen as having a successful monetary policy.

"In the short run, (a weak dollar) can signal all sorts of things, like expected weakness in the economy and lots of speculative things," says Mark Thoma, professor of economics at the University of Oregon. "But if you look at the longer trend, it's based mainly upon the monetary policies in the pair of countries you're examining."

Thoma says a falling dollar signifies, in the long run, that the U.S. has a slightly higher inflation rate than the rival country.

Weak vs. Strong Dollar

Theoretically at least, a weak dollar is better for an economy coming out of a recession while a stronger dollar is better for individuals.

A strong dollar gives Americans more purchasing power in the global marketplace. A weak dollar, on the other hand, can be better for the gross domestic product by making exports cheaper.

"The key is to make a distinction between impact on GDP, which is important in getting out of a recession, and standard of living, which is of paramount interest in normal times," says Bob McTeer, former president of the Federal Reserve Bank of Dallas and distinguished fellow at the National Center for Policy Analysis. "A weaker dollar will stimulate GDP by encouraging exports and discouraging imports."

According to McTeer, a weakening dollar should have the effect of reducing the trade deficit. That hasn't happened, ironically, because the dollar has not been able to deteriorate enough. Countries like China peg their currencies to the U.S. dollar, so those trade patterns tend to be somewhat insulated from fluctuations in the dollar.

But there's another problem: The U.S. is generally not a producer of cheap consumer goods, so it can't compete with countries that have cut-rate labor forces and a willingness to devalue their currency indefinitely.

Here are three ways a weak dollar can make you poor:

No. 1: It Leads to Stagnant Wages and Increased Outsourcing

When dollars are cheap, people overseas can buy more American products, which theoretically helps manufacturers and may even produce jobs here at home.

"It's more expensive for goods to come into the U.S., so more people will buy U.S. goods and indirectly help consumers by providing more job growth," says Thoma.

But there's a slight snag: When the dollar is weak, the relative price of global commodities goes up. It becomes more expensive for U.S. manufacturers to produce anything.

"If you are corporate America, you are squeezed; you have high input costs and very little pricing power at the selling side. These high commodity prices are putting additional pressures on corporate America to accelerate outsourcing, and that is one of the key reasons that real wages haven't gone anywhere," says Axel Merk, president and CIO of Merk Investments.

Merk says a weakened dollar improves quarterly earnings for U.S. multinationals since it improves exports.

But these corporations aren't sharing their increased earnings by hiring domestic employees. In April, The Wall Street Journal reported on recent data from the U.S. Commerce Department showing that multinational companies had trimmed 2.9 million jobs in America through the past decade, while increasing hiring overseas to the tune of 2.4 million jobs.

No. 2: Gas and Luxury Goods Cost More

"The bulk of the world's commodities are priced in U.S. dollars. A drop in value in the U.S. dollar translates to higher prices for commodities," says Mario Singh, director of training and education at FXPRIMUS, a retail foreign exchange brokerage firm.

American consumers may not immediately feel increases in the price of copper or wheat, but they do feel pain at the gas pump. Because almost all oil trading is done in dollars, analysts suspect oil producers like OPEC raise their prices when the dollar falls.

Other imported goods, such as French wines or Italian purses, cost more as well.

"U.S. importers of luxury goods tend to be smaller businesses that don't use more sophisticated financial tools, like hedging or swaps, and also have little negotiation power with their foreign suppliers," says Philip Guarino, owner of Elementi Consulting, an international business consulting firms. "Also, their manufacturers, especially if they are from Europe or Japan, are most likely pricing in euro or yen."

No. 3: Overseas Trips Are More Expensive for Americans

Compared to shredding the purchasing power and income of Americans, pricier overseas jaunts may seem like small potatoes.

But consider that many Americans may have visited Mexico where the dollar still buys a lot of pesos. It's easy to shop in these circumstances. But hop over to France or Germany and suddenly you have to pay a huge premium for nearly everything.

"The strength of the currency is really a reflection of the strength of the economy and the nation. Most importantly it is a reflection of the fact that your currency is a store of value. You can save and that money will buy you something down the road," says Merk.

Today, Americans are working harder and getting less in return. If you've been feeling that a dollar won't go as far as it used to -- you're right, it won't.

Fortunately, a weak dollar is a cyclical phenomenon. It's likely only a matter of time before the dollar strengthens against rival currencies.