



# Foundation for Teaching Economics

*introducing young individuals to an economic way of thinking*

## Hot Topic: The Dollar's Comeback?

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### STUDENT READING

On July 15, 2008, the dollar was at its lowest level against the Euro (\$1.6038 per Euro) since the Euro's inception in 1999. By September 11, 2008, the dollar had rallied to a one-year high of \$1.3882/€. Now, amid fears of a looming recession, possible inflation, and the credit crisis, many people are left wondering what's in store for the dollar.

While economics is not a crystal ball, applying an economic way of thinking to current events can help analyze changes in the market place.

### Background

An exchange rate is the price of a currency in terms of another currency. Just as the prices for goods and services are determined by the supply and demand for those goods and services, the price of a currency is determined by the supply and demand for it.

In order to buy American goods or assets, you need American dollars. Likewise, in order to buy European goods or invest in European assets, you need Euros. To get some of another currency, you have to trade some of your own, and the foreign exchange market is where currencies are traded.

Americans enter the foreign exchange market with dollars to trade. That means they are the suppliers of dollars and the demanders of other currencies. Individuals in other countries who want dollars are the demanders of dollars and the suppliers of their own currencies.

Anything that makes a currency relatively more scarce in a foreign exchange market is going to result in a higher price (a.k.a. a higher exchange rate) for that currency. Anything that makes a currency less scarce in a foreign exchange market is going to result in a lower price (a.k.a. a lower exchange rate) for that currency.

The changing value of a currency can be expressed many ways. Below are examples of statements that refer to a rising dollar (on the left) and a falling dollar (on the right).

The dollar is up.  
The value of the dollar has risen.  
The dollar appreciated relative to the yen.  
The dollar rose against the yen.

The dollar is down.  
The value of the dollar has dropped.  
The dollar depreciated relative to the yen.  
The dollar fell against the yen.

Keep in mind that although we often refer to the exchange rate or the value of the dollar, there are many exchange rates - a different one for the dollar - a different one for each currency in the foreign exchange market. When you hear someone say "the dollar is down today," ask yourself "compared to what other currency?" Also remember that the dollar may be "down" relative to the Euro at the same time that it is "up" relative to the yen.

Just as consumer and producer expectations influence the demand and supply, and ultimately the prices, of goods and services, the expectations of the buyers and sellers of dollars affect the prices of dollars in the foreign exchange market. There are many forces acting on the supply and demand for dollars every day. Whether the dollar rises or falls against another currency depends on which forces have the greatest influence.

In the articles that follow, look for the factors influencing the expectations of buyers and sellers of

dollars today. Try to identify events, plans, and situations that might affect the supply of and demand for American dollars, and then use your knowledge of markets to predict how these events would affect the exchange rate of the dollar relative to other currencies.

HINT:

- Will the event make the dollar relatively **more scarce** or **less scarce** in the foreign exchange market?
- Will the event make Americans willing and able to trade **more** or **fewer** dollars for other currencies?
- Will the event make individuals in other countries willing and able to trade **more** or **less** of their currencies for a dollar?

### **Financial Crisis Undermines U.S. Credibility (by Mike Dolan, Reuters, Sept. 24, 2008)**

The financial storm engulfing the world has already left a trail of destruction, but the biggest casualty may yet prove to be the credibility of U.S. government policy, its dollar and Treasury debt.

...After government bailout upon bailout this month, JP Morgan estimates total net sales of U.S. public sector debt in the fiscal year ahead - both to finance a large budget deficit and the huge purchase of distressed assets - could approach \$1.5 trillion, or about 10 percent of U.S. gross domestic product.

Either Washington increases taxes to cover that debt, inflates it away by printing money - including engineering a fresh slide in the dollar - or it pays a higher interest bill for the privilege of retaining overseas creditors.

...Analysts at Merrill Lynch on Monday advised clients to sell U.S. dollars as a result of the huge and rising fiscal costs, the pressure on the U.S. AAA rating and the debt to the overall credibility of the U.S. assets and policy making.

<http://www.iht.com/articles/2008/09/23/business/col24.php>

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### **Dollar Edges Up, but Bailout Uncertainty to Cap Gains (Reuters, Sept. 23, 2008)**

The U.S. dollar rebounded on Tuesday from its record one-day loss versus the Euro, drawing support from weak Euro-zone data and lower crude oil prices.

Uncertainty about the U.S. government's bailout plan aimed at restoring confidence in its troubled financial sector should limit the dollar's advance, analysts said. Investors were concerned about how quickly the U.S. Congress can hammer out a deal on the \$700 billion bailout package.

'The dollar recovered primarily off very weak readings of Euro zone data, which pretty much telegraph that the Euro-zone economy has come to a standstill,' said Boris Schlossberg, director of FX research at Global Forex Trading in New York.

'But the dollar has since come off its intraday highs as markets await the details of the U.S. bailout plan. The main concern for the currency market right now is the fiscal and economic stability of the United States.'

<http://www.forbes.com/afxnewslimited/feeds/afx/2008/09/23/afx5459015.html>

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### **US Dollar Tumbles as Bailout Plan Stokes Deficit Concern (by Vivianne Rodrigues, Sept. 22, 2008)**

NEW YORK, Sept 22 (Reuters) - The U.S. dollar tumbled, hitting multiweek lows against the Euro and against sterling on Monday as the U.S. government's bailout plan to ease a financial credit crisis reignited worries about the country's massive budget deficit.

...But analysts say foreign investors will be increasingly reluctant to finance the growing U.S. deficit at the current dollar exchange rate and that funding the gap would require higher interest rates and a weaker currency.

'Nobody knows what form the bailout package will take. We only know vaguely how much it will cost'" said Ron Simpson, director of currency research at Action Economics in Tampa, Florida. The U.S. fiscal position 'does not look pretty for this year and next ... Overall, the uncertainty is driving the current flight out of the dollar,' he added.

<http://www.reuters.com/article/usDollarRpt/idUSN2232766720080922>

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### **Dollar Falls Versus Euro as Congress Delays U.S. Bailout Plan (By Stanley White and Ron Harui, Bloomberg.com, Sept. 24, 2008)**

Sept. 24 (Bloomberg) -- The greenback also approached a one-month low versus the British pound before a report that economists forecast will show U.S. home sales dropped, bolstering the case for a Fed interest- rate cut. The Australian and New Zealand dollars weakened as prices for commodities the countries export declined.

'The dollar will face a lot of pressure to go lower,' said Tsutomu Soma, a bond and currency dealer at Okasan Securities Co. in Tokyo. 'Uncertainty about when the U.S. rescue package will pass and how much of a burden it will place on future generations is damaging confidence in the dollar.'

'The housing market is still slowing and the poor state of the economy is likely to continue,' said Michiyoshi Kato, a senior vice president of currency sales in Tokyo at Mizuho Corporate Bank Ltd., a unit of Japan's second-largest bank by assets. 'Sentiment is bad toward the dollar,' which may weaken to 105 yen today, he said.

<http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=aRfA5woxMy4c>

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#### **Questions for Discussion:**

In light of the analysis in the articles above, consider the following possibilities. What impact might each have on the value of the dollar relative to other currencies? Explain.

1. The bailout plan averts a recession and results in a stabilization of the U.S. economy.
2. Corporate tax rates are raised to pay for the bailout of companies in the financial industry.
3. The U.S. government successfully pressures the Fed to increase the money supply to help pay for the financial-industry bailout.
4. The U.S. government offers a higher interest rate on U.S. government securities.
5. Merrill Lynch advises clients to sell U.S. dollars.
6. Belief in the security and credibility of the U.S. government declines.
7. The European economy comes to a standstill.
8. The U.S. economy falls into a recession.
9. Uncertainty prevails as to the U.S. fiscal position (the government's ability to pay for the services it provides) as employment and tax revenues fall.
10. Assets the U.S. government is taking on in the financial industry turn out to be largely undervalued – meaning they're getting them at bargain prices and will be able to sell them at higher prices down the road.
11. The Fed reduces interest rates and home sales in the U.S. begin to pick up.

## TEACHER GUIDE

### Answers for Discussion Questions

\*NOTE: See possible answers below. However, the vagueness of the scenarios means that student answers will vary. Accept reasonable arguments based on solid analysis of supply and demand.

1. The bailout plan averts a recession and results in a stabilization of the U.S. economy.

*INCREASE:*

*Foreigners and Americans alike would likely be more confident in investing in the U.S. economy if it were "stabilized" and not facing a recession. To invest in U.S. assets you need U.S. dollars. U.S. dollars would be more scarce in the foreign exchange market and the value of the dollar would generally rise.*

2. Corporate tax rates are raised to pay for the bailout of companies in the financial industry.

*DECREASE:*

*Higher corporate taxes could result in higher prices for the goods and services produced by those companies as well as lower profits and thus lower returns for investors. If foreigners buy less U.S. goods and invest in fewer U.S. assets, they won't need as many dollars. Dollars would be less scarce and the price they'd be willing to pay for them would fall – a.k.a. the dollar would depreciate.*

3. The U.S. government successfully pressures the Fed to increase the money supply to help pay for the financial-industry bailout.

*DECREASE:*

*In this case, there would be more dollars chasing the same amount of another currency. There are more dollars so dollars would be less scarce, or, in other words, individuals would be willing to trade MORE dollars for one unit of the other currency. For example, if last month people were willing to pay \$1.30 for a Euro, and today they are willing to pay \$1.50, then the dollar has depreciated relative to the Euro.*

4. The U.S. government offers a higher interest rate on U.S. government securities.

*INCREASE:*

*Higher interest rates will encourage more foreign investors to invest in U.S. bonds. Dollars would be more scarce. The value of the dollar would rise.*

5. Merrill Lynch advises clients to sell U.S. dollars.

*DECREASE:*

*This would increase the supply of dollars in the foreign exchange market as many more people are now willing and able to sell their dollars in exchange for another currency. Dollars are less scarce. The value of the dollar would fall.*

6. Belief in the security and credibility of the U.S. government declines.

*DECREASE:*

*Foreign investors would demand fewer dollars. Dollars would be less scarce. The dollar would depreciate relative to other currencies.*

7. The European economy comes to a standstill.

*INCREASE:*

*The dollar and U.S. investments won't look as bad to foreign investors if the European economy is slowing as well. At the same time, Americans would be willing to trade fewer dollars for Euros. Dollars would become more scarce. The dollar would appreciate relative to the Euro.*

8. The U.S. economy falls in to a recession.

**DECREASE:**

*Lower productivity could result in lower returns on many U.S. investments. Foreign investors would demand fewer dollars, making dollars less scarce. The value of the dollar would fall relative to other currencies.*

9. Uncertainty prevails as to the U.S. fiscal position (the government's ability to pay for the services it provides) as employment and tax revenues fall.

**DECREASE:**

*Generally investors are cautious amidst uncertainty. Foreign investors would be less likely to invest and would demand fewer dollars. The value of the dollar would fall relative to other currencies.*

10. Assets the U.S. government is taking on in the financial industry turn out to be largely undervalued – meaning they're getting them at bargain prices and will be able to sell them at higher prices down the road.

**INCREASE:**

*This would likely restore consumer and investor confidence – not just domestically, but among foreign consumers and investors as well. More foreign consumers and investors would be willing and able to buy dollars with their currencies. Dollars would become relatively more scarce and the dollar would appreciate relative to other currencies.*

11. The Fed reduces interest rates and home sales in the U.S. begin to pick up.

**DECREASE:**

*Lower interest rates mean lower returns for foreign investors. They would want fewer dollars to invest in the U.S. economy. Dollars would be less scarce and the value of the dollar would fall relative to other currencies.*

**EXTENSION ACTIVITY**

Have students look up, track, and graph the exchange rate for the dollar vs. five other currencies over the course of a month. Have them collect headlines from news articles in papers, journals, and on the web and hypothesize as to factors and events that may be influencing changes in exchange rates.

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