February 6, 2023

Strong Dollar: Implications for U.S. Economy

Over the past decade the U.S. dollar has generally increased in value relative to other currencies, reaching new heights since the beginning of the current economic expansion. This appreciation resulted from domestic and international economic conditions but also directly affects the U.S. economy, notably in its effect on trade. This In Focus discusses the recent strengthening of the dollar, potential causes and effects, and policy implications.

Recent Trends

To determine the value of the dollar, economists compare it to other currencies. These comparisons are known as *exchange rates* and measure how much of one currency a unit of another currency can purchase.

To consider how the value of the dollar has changed over time in relation to multiple currencies, the Federal Reserve produces a number of indexes. One such measure, the broad dollar index, is shown in **Figure 1**. The Fed calculates the broad dollar index using the currencies of major U.S. trading partners (based on volume of bilateral trade). Based on this measure, in both real (inflation-adjusted) and nominal (unadjusted) terms the value of the dollar has been trending generally upwards (*appreciating*) since 2011, peaking in October of 2022 and falling slightly (*depreciating)* since then.

The broad dollar index only provides data back to 2006. Using information from discontinued trade-weighted dollar indexes, this episode is the third time since the United States adopted a floating exchange rate regime in the 1970s that the dollar has undergone extended periods of significant appreciation—it also happened in the first half of the 1980s and again in the second half of the 1990s to the early 2000s.

Causes of the Strong Dollar

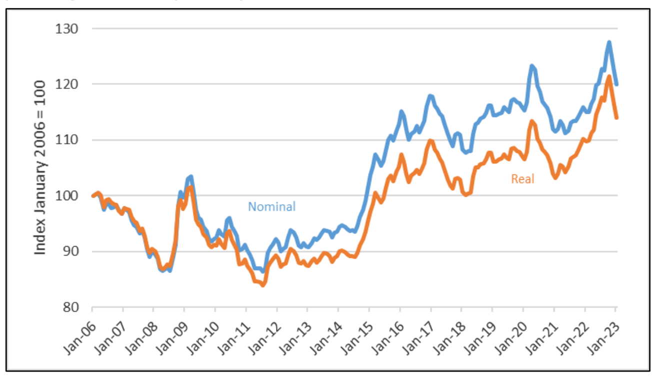
Since the fixed exchange rate regime ended in the 1970s, the value of the dollar has been determined largely by the forces of supply and demand in foreign exchange markets. Participants in these markets—which include a variety of private investors, investment firms, private banks, and central banks, among others—can buy, sell, and exchange currencies, which allows for international trade of goods and services, foreign investments, and other cross-border financial transactions. Factors that have contributed to the dollar appreciation over the past decade include increases in foreign investors' net savings, relative increases in U.S. interest rates, and increasing demand for U.S. assets.

Most recently, dollar appreciation has been a result of economic conditions and policy surrounding the COVID-19 pandemic. The pandemic spread globally in early 2020 and caused deep disruption to the U.S. and foreign economies and financial markets. Such a global crisis tends to result in a "flight to safety," whereby investors flock to the dollar, causing it to appreciate. This is what happened in early 2020. As financial markets normalized, the dollar depreciated somewhat.

After a brief period of depreciation, the dollar again began to appreciate in 2021 and continued to do so throughout most of 2022. A number of factors may have contributed to the appreciation since 2021, including the relative speed of economic recoveries, relative interest rate levels, and investor demand for U.S. assets. A prominent reason for the appreciation in 2022 has been relatively fast-paced interest rate increases in the United States compared to other countries. In response to inflation, which began to rise in 2021, the Federal Reserve has been increasing its policy rate fairly aggressively, causing other interest rates in the economy to rise as well.

Figure 1. Broad Dollar Index

January 2006 to January 2023



Source: Federal Reserve H.10 Foreign Exchange Rates.

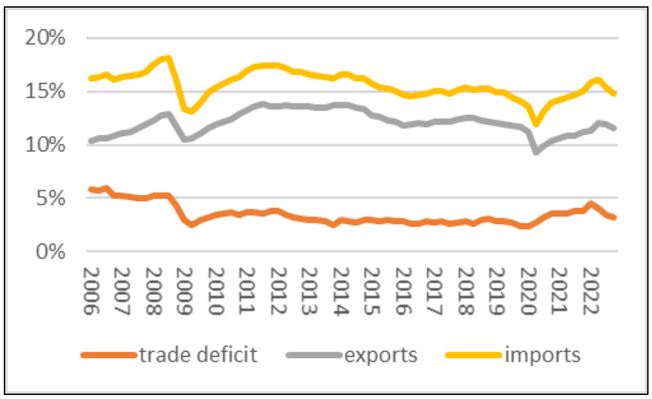
Higher interest rates in the U.S. economy relative to foreign economies make U.S. assets more attractive relative to foreign assets, causing investors to demand dollars to invest in U.S. assets and the dollar to appreciate. For the dollar to remain strong, foreigners must be willing to continue to invest in U.S. assets despite the U.S. negative net international investment position (NIIP, the difference between how much U.S. investors have invested abroad and how much foreigners have invested in the United States) of over $16 trillion. Foreigners may nevertheless be willing to continue investing because (1) the United States has long had a negative NIIP and net capital inflows, (2) the United States has consistently earned positive net income on its NIIP despite it being negative, and (3) the dollar's unique role as the world's reserve currency creates consistent foreign demand to hold dollars for trade and as foreign exchange reserves. For more information, see CRS In Focus IF11707, *The U.S. Dollar as the World's Dominant Reserve Currency*, by Rebecca M. Nelson and Martin A. Weiss.

Economic Effects of a Strong Dollar

Because the value of the dollar is caused by economic conditions in the United States and abroad, one cannot characterize the strong dollar as good or bad for the overall economy. However, the strong dollar does not affect all parts of the U.S. economy the same. Its effects are felt most directly by the U.S. trade sector. All else equal, when the dollar is strong, U.S. exports are relatively expensive compared to foreign-made goods and services, and foreign imports to the United States are relatively inexpensive compared to U.S.-made competing goods.

Thus, a stronger dollar tends to cause the trade deficit (exports less imports) to increase. Generally, the trade deficit has been increasing as a share of gross domestic product (GDP) since the beginning of 2020 and has continued rising since the dollar continued its upward trend in 2021 (see **Figure 2**). The trade deficit was around 2.5%-3% of GDP from 2013 to 2019, then rose to a peak of 4.5% of GDP in the first quarter of 2022, before falling to 3.2% of GDP in the third quarter.

Figure 2. Exports, Imports, and Trade Deficit
Q1 2006-Q3 2022



Source: CRS calculations of Bureau of Economic Analysis data.

Other effects of a strong dollar may provide economic benefits. Cheaper imports allow U.S. consumers to consume more, raising their overall purchasing power. Cheaper imports also allow U.S. businesses to purchase less expensive raw materials and intermediate goods, which companies would be expected to pass on to consumers in the form of lower prices if markets were competitive. During a high inflation period, the strong dollar also mitigates inflationary pressures through lower import prices and lower overall demand. In addition, if the value of the dollar is being driven by capital inflows, then U.S. interest rates would be higher in the absence of those capital flows. When there is an inflow of capital, borrowing becomes cheaper because the amount of loanable funds in the economy increases. Higher interest rates would reduce interest-sensitive spending by U.S. consumers and businesses and make it more expensive to finance the federal budget deficit.

Policy Implications

Policy options could be considered to change the value of the dollar. Given that its value is tied to larger macroeconomic forces, policy attempts to change the value of the dollar would also have short-term implications for inflation, interest rates, output, and other effects.

According to the Bank of International Settlements, foreign currency trading involving the dollar averaged $6.6 trillion per day in 2022, indicating that the exchange rate is dominated by financial flows, as trade flows represent a fraction of that volume. This suggests that any effective policy to change the value of the dollar would depend on reducing interest rates in the United States relative to the rest of the world. (Stated differently, the dollar is likely to remain strong until U.S. interest rates fall relative to foreign rates or foreign interest rates rise relative to U.S. rates.)

Theoretically, interest rates could be reduced through monetary policy or fiscal policy. The effect of monetary policy on interest rates is more straightforward and predictable—but controlled by the Federal Reserve. Furthermore, their implications for the economy are quite different. Reducing rates through monetary policy would stimulate the economy, which would put more upward pressure on inflation—already the highest it has been in decades. By contrast, tightening fiscal policy (i.e., reducing the deficit) would be contractionary, which would mitigate inflationary pressures and reduce interest rates. By reducing the deficit, the U.S. Treasury would have fewer securities for investors to purchase, who would therefore be willing to hold Treasury securities at lower interest rates. Because of the size and importance of Treasury markets, lower interest rates on Treasury securities would feed through to other interest rates throughout the economy. Depending on how mobile capital is and how sensitive trade is to the value of the dollar, a reduction in the trade deficit could potentially offset some of the contractionary effects of deficit reduction. For these effects to be noticeable, the deficit reduction undertaken would have to be sizeable relative to the overall economy.

This analysis also suggests that policy options that would not affect interest rates are less likely to have a lasting effect on the value of the dollar. For example, trade policies to boost exports or restrain imports would be expected to make the dollar stronger, therefore neutralizing their goals. (By increasing export demand or decreasing import demand, such policies would also be increasing the relative demand for the dollar, thereby raising its value.) Other policy options that do not involve changing interest rates are discussed in CRS In Focus IF11296, *U.S. Dollar Intervention: Options and Issues for Congress*, by Marc Labonte and Martin A. Weiss.

Some commentators blame exchange rate intervention by foreign governments (sometimes called "currency manipulation") for the strong dollar. But foreign official holdings of Treasury securities and dollar-denominated official foreign exchange reserves have both been declining in nominal terms since 2021. This seems to rule out manipulation as a primary cause of the strong dollar over that period. For more information, see CRS In Focus IF10049, *Exchange Rates and Currency Manipulation*, by Rebecca M. Nelson.

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