"What is the meaning of a strong and weak dollar and how does a dollar's strength impact Texas imports?" *by Steven S. Shwiff, Ph.D.*

The trade between countries has always been a hot topic of "conversation". The loss of domestic jobs to "foreign countries" ignites strong passions regarding international trade. One need only recall the recent demonstrations against the World Trade Organization. But in fact countries trade with each other because it makes them better off. International trade allows consumers to buy higher quality, lower priced imported goods than can be produced by domestic manufacturers. To understand this, trade is the basis for understanding a "weak or strong" currency.

International trade involves two separate but interrelated transactions. The first is the physical exchange of goods and services. Let's consider the case of Texas and Mexico. Forty-eight percent of all Texas exports go to Mexico. Texas's top exports to Mexico are electronics, industrial equipment (including computers) and chemicals. Texas top imports from Mexico are motor vehicles and parts, crude oil and telecommunications equipment. But remember, a Texas export is a Mexican import and vice versa.

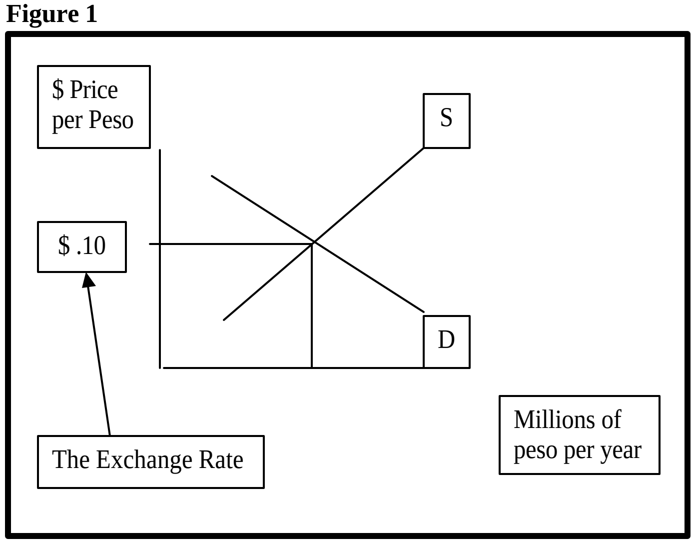
The exchange of goods is only half the transaction. The other half is the payment for those traded goods. Mexicans want pesos so they can buy goods and services at home. Texas exporters want dollars but their Mexican buyers want to pay in pesos. This, therefore, sets up a second international market. This is the market for the demand and supply of currency (pesos and dollars). Americans want "some" pesos because they can use them to pay for imported goods from Mexico. Mexicans want "some" dollars because they can pay for goods imported from the United States with those dollars.

However, you must remember that the demand for payment by a Mexican exporter of motor vehicles is directly linked to the demand for motor vehicles in the United States by Americans. Said another way, the demand in America for motor vehicles is also a supply of dollars to the Mexican exporter. These dollars now become a source of money that can be used by Mexicans to pay for what is bought from America. The flip side of this equation is the supply curve of pesos. Pesos are supplied because Mexican nationals want to buy US exports and they pay for them in pesos. This second market for money allows Mexican importers to convert dollars they get in payment for their exports to Texas into pesos they need to spend in their own economy. The same applies to Texas exporters who are paid in pesos.

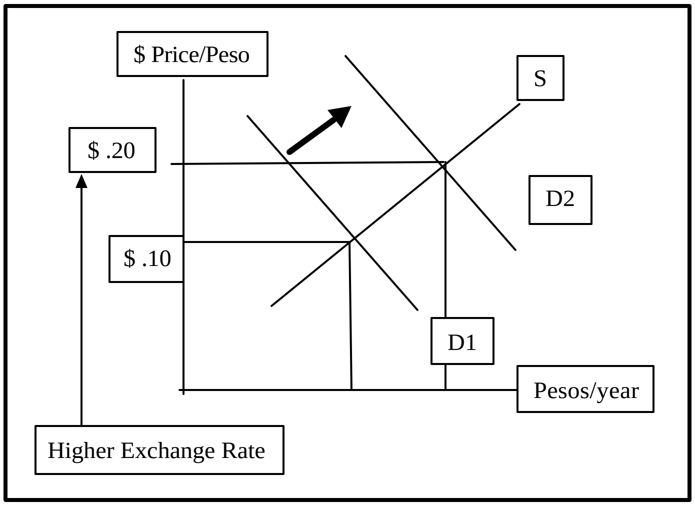
Figure 1 puts these two ideas together. The curve marked S is the supply of pesos (from purchases of US exports) and the curve marked D is the demand curve for imports to Texas (again say motor vehicles and parts). Where these two curves intersect sets what is called the "exchange rate." This exchange rate is the dollar price of a peso or the peso price of a dollar. Currently one US dollar will exchange for 9.53 pesos or 10 cents equals one peso. So that is how the exchange rate is established. By demand and supply for dollars and pesos which is also linked to the demand and supply of goods and services.

Now let us look at the question of a change in the exchange rate. A change in the exchange rate means that the value of one currency in terms of the other will rise or fall. This will occur, if we ignore money speculators, as the result of a change in demand or supply of goods or services. Let us assume that the demand by Americans for imported Mexican motor vehicle parts increases. We can show this by a shift outward of our demand schedule from figure 1.

Figure 1



Now take a look at figure 2. When the demand schedule shifts outward we can clearly see that the dollar price of pesos will change. In fact, the dollar price rises. Thus Americans spend more dollars to buy the same amount of pesos. Thus we say that the peso has appreciated against the dollar or that the dollar has depreciated against the peso. In simple terms we see from figure 2 than the value of the peso has risen.



We have seen what happens when the peso appreciates relative to the dollar. What happens, however, if the dollar appreciates against the peso. What this now means is that Mexicans will have to pay more pesos to buy the same amount of dollars. If this is the case they will not be able to afford as many imported goods from Texas. Since the demand for Texas imports falls, Texas firms will have to cut back production and hours worked. Workers will be paid less in Texas. Since they have less income they will buy fewer imports as and well as domestically produced goods and services. Times for Texans will become more difficult as the economy begins to slow.

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