

## CONCEPT: NOMINAL AND REAL EXCHANGE RATES

- The **nominal exchange rate** is the rate at which one currency trades for another currency
  - Example: A bank trades 108 Japanese Yen for 1 USD → The bank will give you 108 yen for one dollar
  - **Currency Appreciation** – when your currency can buy \_\_\_\_\_ of the foreign currency
    - > Example: The bank now offers \_\_\_\_\_ Japanese Yen for 1 USD
  - **Currency Depreciation** – when your currency can buy \_\_\_\_\_ of the foreign currency
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  - Note: When one currency appreciates, the other currency depreciates! Always!
    - > If the USD can buy *more* Yen, then the Yen can buy *fewer* dollars
- The **real exchange rate** is the price of domestic goods in terms of foreign goods
  - Real exchange rates focus on the **purchasing power** of the currency

**EXAMPLE:** A sandwich costs \$3.00 in the USA and costs 1.50 British Pounds. If the exchange rate is 0.5 British Pounds per USD, what is the real exchange rate?

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$$\text{Real Exchange Rate} = \text{Nominal Exchange Rate in USD} * \frac{\text{USD Price Level}}{\text{Foreign Price Level}}$$

**PRACTICE:** The exchange rate between the USD and GBP is currently \$1.61 = 1 GBP. If the price level in the US is 108 and the price level in the United Kingdom is 114, what is the real exchange rate?