NOMINAL EXCHANGE RATE AND REAL EXCHANGE RATE

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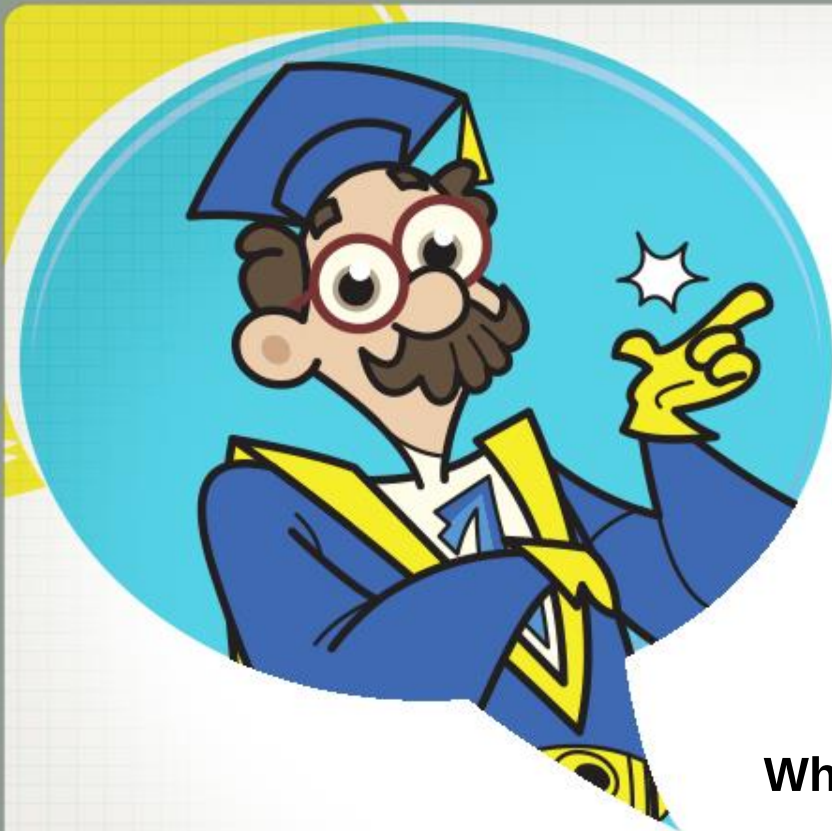

When we say that $1=Rs. 40 we are talking about nominal exchange rate. This is the rate at which you can purchase dollars.

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Now that we understand what is

“Nominal” exchange rate,

let’s understand what “Real”

exchange rate is all about…

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To understand this let's consider an analogy:-

- **Let's say the nominal exchange rates between the currencies of US & India are in the ratio of 1:40.**
- **This means that $1 = Rs. 40.**
- **Now let's say the cost of a McDonald's Burger in the US is $1 .**
- **This means that for a US resident earning in US dollars, the cost of the Burger in India should be Rs. 40.**

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- **Now suppose the rate of inflation in India is 10% while the rate of inflation in US is 0%.**
- **Due to this, the cost of the Burger in India would actually be equal to Rs (40x1.1) = Rs. 44.**
- **Therefore, although the US resident can buy Rs. 40 for $1, he cannot purchase the Burger for $1 in India.**

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- **By the same token, the Burger becomes more expensive for an Indian resident too even though the nominal exchange rate does not change.**
- **This is because, although $1 is still equal to Rs 40, an Indian resident needs Rs. 44 to purchase the same Burger.**
- **Thus this exchange rate, which is in the ratio of 1:44, gets impacted by inflation from the perspective of purchase of products.**
- **This is known as the “Real Exchange Rate”.**

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Hope this lesson has succeeded in clarifying the difference between Nominal Exchange Rate and Real Exchange Rate clearly.

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