Q3. Distinguish between the nominal exchange rate and the real exchange rate. If you were to decide whether to buy domestic goods or foreign goods, which rate would be more relevant? Explain.
Ans:Nominal exchange rate is the price of one currency in terms of another. It is the amount of domestic currency required to buy one unit of foreign currency. For example, a rupee-dollar exchange rate of Rs 45 means that it costs 45 rupees to buy 1 dollar.

Real exchange rate is the ratio of foreign prices to domestic prices. In other words, it measures foreign prices relative to domestic prices.

$$\text{Real exchange rate} = e\frac{P_f}{P}$$

Where P_f – price level of foreign currency

P – Price level of domestic currency
e – Nominal exchange rate
For example, if a watch costs $40 in US and the nominal exchange rate is 50 per US dollar, then, with real exchange rate of 1, it should cost Rs 2,000 ($eP_f = 50 \times 40$ = Rs 2000) in India.

If, I was to decide whether to buy domestic goods or foreign goods, then real exchange rate will be more relevant, because real exchange rate takes the inflation differential among the countries into account and is also used as an indicator of a country's competitiveness in the foreign trade.

Q4. Suppose it takes 1.25 yen to buy a rupee, and the price level in Japan is 3 and the price level in India is 1.2. Calculate the real exchange rate between India and Japan (the price of Japanese goods in terms of Indian goods). (Hint: First find out the nominal exchange rate as a price of yen in rupees).
Ans:Price level in foreign country: (Japan)

$P_f = 3$

Price level in home country: (India) $P = 1.2$

Now, real exchange rate $= e\frac{P_f}{P}$

Price of 1.25 yen = 1 rupee

Price of 1 yen $= \frac{1}{1.25} = \frac{100}{125} = \frac{4}{5}$ rupee

Therefore, $e = \frac{4}{5}$

So, real exchange rate $= e\frac{P_f}{P}$

$= \frac{4}{5} \times \frac{30}{1.2}$

$= 2$

Therefore, the real exchange rate is 2.

Q5. Explain the automatic mechanism by which BoP equilibrium was achieved under the gold standard.

Ans:Under the gold standard system, gold was taken as a common unit for measuring other country's currency. Thus, the value of a currency was defined in terms of gold. The exchange rate in an open market was determined by its worth in terms of gold. It was fixed in lower limits and upper limits; under which it was allowed to fluctuate. So, the exchange rate became stable under gold standard. All the countries maintained stock of gold to exchange currency.

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