change in the price levels of the countries over the same period.[13] This means that if one country's inflation rate over the past year was 5% higher than that of another country, then the currency of the high inflation country should have declined in value by 5%.

That 5% depreciation might lead some observers to conclude that exports should increase, imports should decline and the trade balance should improve. However, the exchange rate change is simply an adjustment mechanism to offset higher domestic prices, and its change will not affect the bilateral trade balance. Such an exchange rate depreciation maintains -- but does not enhance -- the competitiveness of the high inflation country's exports.

Since the nominal (observed) exchange rate can be misleading in terms of its effect on trade, another exchange rate measure is required to account for inflation differentials. The real exchange rate is such a measure; it reflects changes in the nominal rate and changes in the two countries' inflation rates.[14] Continuing with the above example, while the nominal exchange rate reflects a 5% depreciation for the high inflation country, the real exchange rate would show no change since the nominal rate falls by the inflation differential. With respect to trade, the real exchange rate is more relevant than the nominal rate. The real exchange rate determines export profitability since costs (domestic currency) and revenues (foreign currency) are converted to a single currency and price level changes are accounted for.

So far, the discussion of exchange rates has been limited to a bilateral analysis, i.e., exchange rates between only two countries. As a means of expressing a country's exchange rate in terms of a number of other countries' currencies, the concept of effective exchange rates was developed. An effective exchange rate is an index for the local currency price of a basket of foreign currencies. Each foreign currency is assigned a weight according to the foreign country's importance in international trade. The effective exchange rate can be thought of as a country's average cost of foreign exchange, with the average influenced more by the bilateral exchange rates of the country's most important trading partners.[15]

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[13] Although the PPP theory is widely accepted, the empirical evidence supporting this theory is not considered strong.

[14] See Annex 1 for an example of how to calculate a real exchange rate.

[15] See Annex 1 for an example of how to calculate an effective exchange rate.