BHARAT SCHOOL OF BANKING

Purchasing Power Parity (PPP)

PPP Theory

It states that the **exchange rate** of a **currency** with another (currency) is in **equilibrium** when their **domestic purchasing power** are **equivalent** at that **exchange rate**.

It means that a **good** should cost same in **India** and **USA** after considering the **exchange rate** of **Indian Rupee (INR)** and **US Dollar (USD)**.

Example

Suppose, the current **exchange rate** of Indian rupee to US Dollar is **Rs. 60** per **USD** (i.e., 1 USD = Rs. 60). Now suppose a **laptop** costs **Rs. 60,000** in **India**.

According to the **PPP theory**, the **laptop** should cost **USD (60,000 / 60) = USD 1,000** (considering the current **exchange** rate of these two currencies) to maintain **parity** in **purchasing power** of these two currencies.

But, it may happen that the actual **market price** of the **laptop** in **USA** is **USD 800** (say) (equivalent to **Rs. 48,000** in **India**). Therefore, there is an advantage of **buying** the **laptop** in **USA** at much less price than India (**Rs. 12,000 less**) (it means that the **purchasing power** is not in **parity** between these two currencies)

What happens if not in parity?

Indian consumers will go to the **exchange office** and sell their **INR** and buy **USD**, and then buy the laptop from USA. It will cause the Indian currency **less valuable** than the US dollar.

The **demand** of **laptop** sold in **India** will **decrease** (since high price), and the **price** of laptop will go down. In contrast, the **demand** of laptop in **USA** will increase, and the **price** will rise accordingly.

These factors will cause the **exchange rate** (of the currencies) and the **prices** (of laptops) to change such that there is **purchasing power parity** in both the currencies.

Long term effect

PPP theory tells us that the **price differences** between countries are **not sustainable** in the long run, as **market forces** will **equalize** prices between the **countries** and change the **exchange rates** accordingly.

(Relate the above example with **companies** that can buy goods in much less price from foreign countries and sell in much less price in India than its counterparts. For this reason, there are several laws or restrictions on **imports** and a provision of levying **customs duty**, etc.)

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