PURCHASING-POWER PARITY

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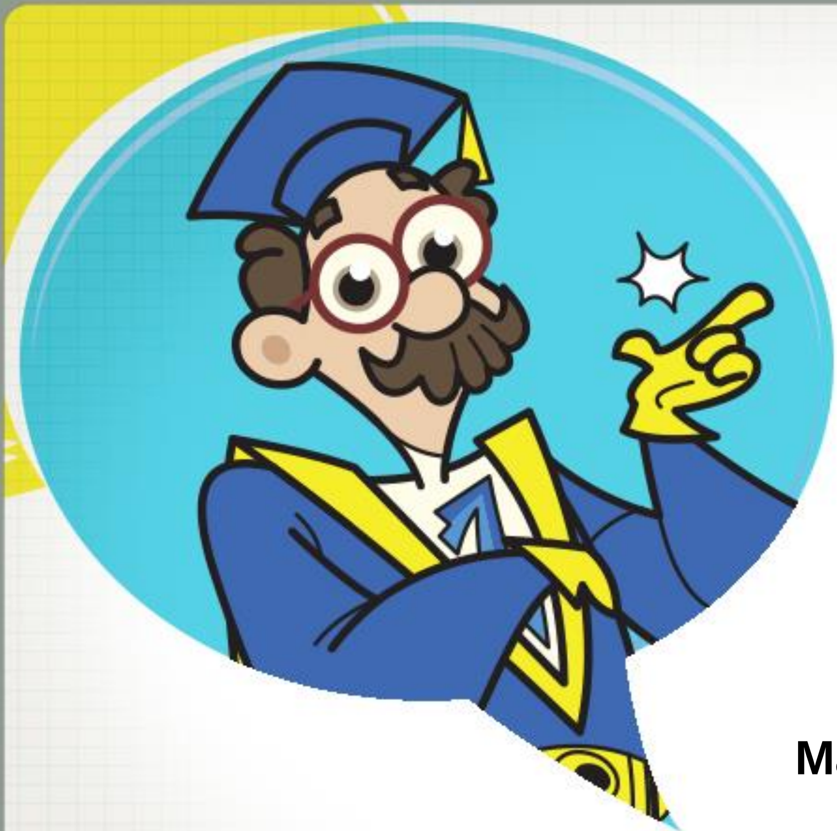

Many of you have written to me asking for the meaning of Purchasing-Power Parity (PPP). So what is it?

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- **The purchasing power parity (PPP) theory measures the purchasing power of one currency against another after taking into account their exchange rate.**
- **'*Taking into account their exchange rate*' simply means that you measure the strength of purchasing power on $1 with that of Rs 50 and not with Rs 1 (assuming the exchange rate is $ 1 = Rs 50).**
- **Developed by Gustav Cassel in 1918, the theory states that, in ideally efficient markets, identical goods should have only one price.**

Understanding the

purchasing-power parity

i.e. PPP Theory

– By Prof. *Simply* Simple

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- Simply put, what this means is that a bundle of goods should ideally cost the same in Canada and the United States.

- However, if it doesn't happen then we say that purchasing power parity does not exist between the two currencies.

- Lets look at an example…

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First…

- **Suppose that one U.S. Dollar (USD) is currently selling for fifty Indian Rupees (INR)**
- **In the United States, wooden cricket bats sell for $40 while in India, they sell for 750 Rupees.**
- **Since 1 USD = 50 INR, the bat which costs $40 USD in U.S costs only 15 USD if we buy it in India.**
- **Clearly there's an advantage of buying the bat in India, so consumers would be happier to buy the bat in India.**

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- If consumers decide to do this, we should expect to see three things happen:

1. American consumers' demand for Indian Rupees would increase which will cause the Indian Rupee to become more expensive.
2. The demand for cricket bats sold in the United States would decrease and hence its prices would tend to decrease.
3. The increase in demand for cricket bats in India would make them more expensive.
4. Thus the prices in the US and India would start moving towards an equilibrium.

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So what happens now?

- In an ideal scenario, prices in both countries would become equal at some price point.
- The increased demand for INR, for instance may lead an increase in its value such that 1 USD = 40 INR.
- Secondly, due to decrease in demand for the bats in the US, its price drops to USD 30.
- Thirdly, the increase in demand for the bats in India takes its price up to INR 1200.
- At these levels you can see that there is ‘Purchase Price Parity’ between both the currencies.
- This also means that whether you buy the bat in US or in India, it is one and the same thing for the consumer.

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This is because a consumer can spend $30 in the United States for a cricket bat, or he can take his $30, exchange it for 1200 Rupees (since 1 USD = 40 INR) and buy a cricket bat in India and be no better off.

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So…

- **Purchasing-power parity theory tells us that price differentials between countries are not sustainable in the long run as market forces will equalize prices between countries and change exchange rates in doing so.**
- **You might think that my example of consumers crossing the border to buy cricket bats is unrealistic as the expense of the longer trip would wipe out any savings you get from buying the bat for a lower price.**
- **However it is not unrealistic to imagine an individual or company buying hundreds or thousands of the bats in India, then shipping them to the United States for sale.**

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Also…

- **It is also not unrealistic to imagine a large retail store purchasing bats from the lower cost manufacturer in India instead of the higher cost manufacturer in India.**
- **In the long run, having different prices in the United States and India is not sustainable because an individual or company will be able to gain an arbitrage profit by buying the good cheaply in one market and selling it for a higher price in the other market.**
- **You could read my lesson on 'arbitrage' to understand the concept better:** **http://www.tatamutualfund.com/Knowledge-Center/arbitrage.swf**

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To Sum Up

- **What: ‘Purchasing Power Parity Theory’ is a theory which states that in ideally efficient markets, identical goods should have only one price.**

- **Why: Because of arbitrage opportunities market forces come to play and bring about an equilibrium in prices.**

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Hope you have now

understood the concept of

Purchasing Power Parity Theory

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