# *PURCHASING POWER PARITY*

- One of the most controversial theories.
- Based on the inflation exchange rate relationship.
- In its absolute form also called “ law of one price.”

# *PURCAHSING POWER PARITY*

- This theory suggests that price of similar products of two different countries should be equal, if they are measured in a common currency.
- If there exists any difference then the demand should shift from one country to another in such a way that prices will have to converge.

# *PURCHASING POWER PARITY*

- For instance,  a product of the same quality and size is produced both by India and China. As per the theory, if measured in common currency the price of the product in India will be equal to that of China.
- But if the price is lower in China then the demand for the product in China will increase and that in India will decrease.

# *PURCHASING POWER PARITY*

- Decrease in demand will ultimately lead to decrease in the price in India till they equate each other.
- In reality, this theory in its absolute form does not actually happen as there exists market imperfections in the form of different levels of technology, cost of production, taxation schemes , transportation costs etc.

# *RELATIVE FORM OF PPP*

- This form of PPP does takes into account the market imperfections.
- It does accepts the fact that the price of same product in two different countries need not be same, even if measured in the common currency.

# *RELATIVE FORM OF PPP*

- However, it does states that the rate of change in prices of similar products in different countries will be somewhat same, when measured in the common currency.
- Here the assumption is that the transportation cost and other trade barriers remain same.

# *RELATIVE FORM OF PPP*

- Assume that the two countries have zero inflation and the current inter-country trade or the exchange rate between the two countries is in equilibrium.
- With the passage of time both the countries will experience some inflation and the exchange rate between the two countries will automatically adjust itself in such a manner so that the difference in the rate of inflation will be offset. In such a situation, the prices of the products in the two countries will appear similar to its citizens.

# *RELATIVE FORM OF PPP*

- This means that the consumer will note little differences in their purchasing power when compared between the two countries.
- Thus the change in exchange rates is equal to the difference in inflation rates which almost neutralises the effect of each other.

# *WHY PPP DOES NOT HOLD GOOD ?*

- Exchange rate are also affected by factors other than inflation differential like income level, government control or the interest rate etc.
- For instance the inflation in India is more than that of China by 5% . As per PPP , the Indian rupee shall depreciate by 5% against the Japanese Yen.

# *WHY PPP DOES NOT HOLD GOOD?*

- Now if the Indian government has imposed restriction on the imports from Japan then the Indian consumers and firms will not be able to adjust their spending in reaction to inflation differential.
- Therefore, the exchange rate will not adjust itself in reaction to difference in inflation rates.

# *INTEREST RATE PARITY (IRP)*

- This theory provides a linkage between the foreign exchange market and the international money market.
- The difference in the national interest rates on securities with similar risk and maturity should be equal to, but opposite in sign, to the forward discount or premium for a foreign currency.