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ECONOMICS

UG Semester - 4 [MJC - 6]

INTERMEDIATE MACROECONOMICS

Unit 3

PURCHASING POWER PARITY

The purchasing power parity theory was propounded by Professor Gustav Cassel of Sweden. According to this theory, rate of exchange between two countries depends upon the relative purchasing power of their respective currencies. Such will be the rates which equates the two purchasing powers.

For example, if a certain assortment of goods can be had for £1 in Britain and a similar assortment with Rs. 80 in India, then it is clear then the purchasing power of £1 is equal to the purchasing power of Rs 80.

Thus, the rate of exchange, according to

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purchasing power parity theory, will be
£1 = Rs. 80

Again, if $1 = 45 rupees.
Now, suppose the price levels in the two countries remain the same but somehow market exchange rate moves to

$ = 46 rupees.

This means that in USA 1 US$ can purchase commodities worth 45 rupees. It will pay people to convert dollars into rupees at the exchange rate, (\$1 = Rs. 46), purchase the given collection of commodities in India for 45 rupees and sell them in USA for one dollar again, making a profit of 1 rupee per dollar worth of transactions.

This will create a large demand for rupees in the USA while supply thereof will be less because very few people would export commodities from USA to India.

The value of the rupee in terms of the dollar will move up until it will reach $1 = 45 rupees. At that point, imports from India will not give abnormal profits. $1 = 45 rupees is called the purchasing power parity between the two countries.

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