Syllabus Reference 3.1: Purchasing Power Parity theory http://economics.isdedu.de

PPP
PPP$
What is it?

PPP

What can a currency buy inside the country?

PPP

If a man in Manhattan has 100$ and the price of bread is 1$. Man can buy 100 piects of bread

PPP

What does the same piece of bread cost in Timbuktu?

PPP

25 cents
This results in purchase of 400 pieces of bread. Who is better off?

PPP

Who is better off?

Man in Timbuktu. PPP $ then expresses the local buying power of the local currency

WHEN DO THE FLOATING RATES STOP FLOATING?
In practice, the above question has a simple answer - **never.** However, in theory, they would stop floating when supply of a particular currency came to equal demand for it. This would occur if the greatest cause of supply and demand were in equilibrium, i.e. the balance of trade. A Swedish economist, Gustav Cassels, brought forward a theory in 1916 suggesting how exchange rates might reach equilibrium.

This is known as the purchasing power parity theory. The best way to explain this theory is to give an illustration of how it might work.

Exam focus:
Explain how allowing for differences in purchasing power may give a more realistic value of the average GDP per head in India. (4 marks, from HP3, Nov 06 q5 part b)

Use the 'Big Mac Index' as a real world example of the significance of PPP.

Definition :
Exports would equal imports if the amount which can be bought inside and outside the countrywith one dollar were identical- equal buying power inside and outside the country = Purchasing power parity

Big Mac Index

Burgernomics is based on the theory of purchasing-power parity, the notion that a dollar should buy the same amount in all countries. Thus in the long run, the exchange rate between two countries should move towards the rate that equalises the prices of an identical basket of goods and services in each country. Our "basket" is a McDonald's Big Mac, which is produced in about 120 countries. The Big Mac PPP is the exchange rate that would mean hamburgers cost the same in America as abroad. Comparing actual exchange rates with PPPs indicates whether a currency is under- or overvalued.

WEBLINK

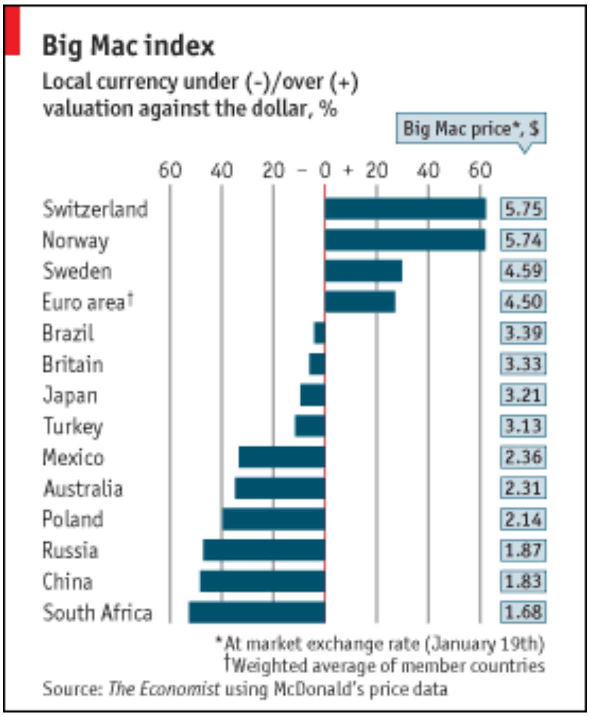
- **1.5 mins- definition**

http://www.economist.com/markets/Bigmac/Index.cfm

- **8 mins- some examples and analysis**

http://www.youtube.com/watch?v=6F9xIj1YDxo

Big Mac index



Jan 22nd 2009

The dollar's recent revival has made fewer currencies look dear against the Big Mac index, our lighthearted guide to exchange rates. The index is based on the idea of purchasing-power parity, which says currencies should trade at the rate that makes the price of goods the same in each country. So if the price of a Big Mac translated into dollars is above $3.54, its cost in America, the currency is expensive; if it is below that benchmark, it is cheap. There are three noteworthy shifts since the summer. The yen, which had looked very cheap, is now close to fair value. So is the pound, which had looked dear the last time we compared burger prices in July. The euro is still overvalued on the burger gauge, but far less so than last summer.