CONCEPT: PURCHASING POWER PARITY

● ***Purchasing Power Parity (PPP)*** states that exchange rates move to equalize the purchasing power of currencies

□ You should be able to buy the same amount of goods with “equal” amounts of money in any country

1. The exchange rate is £1 = $1 and the price of a Coke is $1 in the USA and £1 in the United Kingdom.

The dollar and the pound have __________ purchasing power

2. The exchange rate is £1 = $1 and the price of a Coke is $1 in the USA and **£2** in the United Kingdom.

The dollar and the pound have __________ purchasing power

The exchange rate would need to move to _______ = $1 to keep *purchasing power parity*.
You could buy a Coke in the US for $1 or trade the $1 for _______ and then buy one Coke in the United Kingdom.

Now, the dollar and the pound have __________ purchasing power again

If the exchange rate does not adjust for the change in price levels, the opportunity for profit arises

EXAMPLE: £1 = $1 and Coke prices are $1 and **£2**

Buy 1 million Cokes for $1,000,000 in the USA → Sell the 1 million Cokes for £2,000,000 in the United Kingdom →

Trade the £2,000,000 for dollars at £1 = $1 and end up with $2,000,000.

Note: As many people attempted this profit scheme, they would bid up the price of the dollar until PPP is reached at £2 = $1

● Purchasing power parity is not a complete explanation of changes in exchange rates because of real world issues:

□ *Not all products can be traded internationally*

> Example: Doctors services cannot be bought in one country and sold in another country

□ *Consumer preferences*

> Consumers in one country may be willing to pay a higher price for a certain product

□ *Barriers to trade*

> ***Import Quota*** – a government-mandated maximum quantity allowed to be imported

> ***Tariff*** – tax imposed on imports