Purchasing Power Parity [UPSC Notes]

The formula of Purchasing Power Parity

The concept of purchasing power parity is to balance the rate of exchange among the countries so that any particular product or service can be accessible to each and every customer on a global level without any discrimination in the cost.

- This means keeping the conversion rate so balanced that any product or service costs a person the same price no matter in what country the customer resides or from which country the customer makes the purchase.
- This enables us to keep the prices the same for the products and enables the customers to purchase them at the same price in any part of the world.

Let's understand this with the example given below-

If there is a country A where a product X costs 5000 units (say 5000 rupees if the country is India). To purchase the same product in another country, a customer wants to spend the same amount of money. Because of PPP, it will be possible for him to spend the same amount. Hence, the same product in country Y costs 65 units (say 65 dollars if country Y is to be the USA).

Therefore, the PPP formula could be derived as-

$S = P1/P2$ Where, S = Exchange rate of currency 1 to currency 2, $P1$ = Cost of good in currency 1, and $P2$ = Cost of the same good in currency 2.

The above-mentioned formula is being used to calculate the PPP of a country's currency against the currency of any other country.

Importance of Purchasing Power Parity

The significance of the purchasing power party is mentioned below:

- The calculation of purchasing power parity is done on the basis of the shared prices for listed products in the economies of all the member nations. This enables the currency of a country to act as a substitute in another country's economy.
- Because of the balancing scenario of PPP, the fluctuations in the prices across the countries are reduced.

- Another significance of the purchasing power parity is that it applies checks and measures to the leading economies of the world to prevent them from having their monopoly over the market.
- Purchasing power parity is one such balancing tool used worldwide to maintain the uniformity and accessibility of a country’s market to global consumers.

Problems with Purchasing Power Parity

Certain issues are involved in maintaining purchasing power parity at the global level. Some of them are mentioned here.

- The calculation of the PPP gets affected by the variable market prices in different countries worldwide.
- Unavailability of products in the regional market leads to the importation of the products, which includes the cost of transportation and other expenses as well as taxes and duties. This causes a rise in the overall cost of the product.
- The cost of the products also varies when there are different types of taxes in different markets.
- In some markets, the prices of the products are also raised in order to outcast the competing member.

Purchasing Power Parity India

India has jointly chaired the International Comparison Program (ICP) launched by the World Bank in the year 2017 with Statistics Austria.

- India has been an active participant in all the International Comparison Programs ever since the ICP was started in 1970.
- The Purchasing Power Parity of the Indian Rupee has increased from 15.55 in 2011 to 20.67 in 2017 in comparison to the US Dollar.

- India holds the third position in terms of Purchasing Power Parity.