Term

Purchasing Power Parity (PPP)

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Definition

The term “Purchasing-Power Parity” (PPP) expresses income in terms of buying power and attempts to neutralize the influence of exchange rate differences on cross-country comparisons of income.

Context

The Gross Domestic Product (GDP) is measured in American dollars and is consequently influenced heavily by changes in local exchange rates. The PPP presents GDP in "international dollars," such that each international dollar can purchase the same basket of goods and services in the local economy that an American dollar can purchase in the United States.[1]

According to economic theory, in an efficient market, identical goods and services should be priced equally. An implication of this theory is that currency values calculated by exchange rates based on PPP will be able to purchase equal amounts of identical goods and services.

Currency exchange rates based on PPP are used to compare the Standard of Living in economies using different currencies. This method is an improvement upon standard GDP comparisons which are based upon market exchange rates. As an extension, to eliminate the effects of inflation on the exchange rate, the similar concept Relative PPP is sometimes used.

PPP as a means of comparing countries is controversial. The difficulty of identifying a basket of goods and services that is identical across countries calls into question the accuracy of Standard of Living comparisons given by PPP calculations. Therefore, this document assumes that the relevant economies are open. In reality, transportation costs, tariffs, and quotas inhibit free trade.

End.

[1] See The Economist: Economic Terms A-Z

