Date ___/___/______

Date :- 28/4/2020	Degree Part-II (Hons.)
Content Writer:-	Paper :- IV
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TOPIC :- THE PURCHASING POWER PARITY THEORY

Prof. Cassel suggested Purchasing Power Parity as the appropriate level at which the exchange rate could be set. The basic principle underlying the Purchasing Power Parity theory is that foreign exchange is demanded by the nationals of a country because it has the power to command goods in its own country. When the domestic currency of a nation is exchanged for foreign currency, what in fact happens is that domestic Purchasing Power is exchanged for foreign Purchasing Power. It follows that the main factor determining the exchange rate is the relative Purchasing Power of the two currencies are exchanged, what is exchanged in fact is the international Purchasing Power of the two currencies. Thus, the equilibrium rate of exchange should be such that the exchange of currencies would involve the exchange of equal amounts of Purchasing Power. Hence, it is the Parity of the Purchasing Power of the currencies which determines the exchange rate. Thus, the theory states that the rate of exchange tends to rest at a point at which there is equality between the respective Purchasing Power of the currencies. In other words the rate of exchange between two inconvertible paper currencies tends to approximate the ratio of their Purchasing Power.

The theory, however, has been presented in two versions namely as the absolute version and the relative version.

Absolute version :-

The absolute version of the Purchasing Power Parity theory stresses that the exchange rates should normally reflect the relation between the internal Purchasing Powers of the various currency units, that is to say, the exchange rate should equal the ratio of the outlay required to Purchase a Particular set of goods at home as compared with what it would buy abroad. Therefore, this has been asserted that the equilibrium rate of exchange between paper currencies is determined by the ratio of their internal Purchasing Power. The absolute doctrine is based on the assumption of equality of trade.

Relative Version :-

The relative version of the Purchasing Power Parity theory is propounded by Prof. Cassel as a means for measuring departures from "equilibrium." As compared to absolute doctrine, it is stated in a more modest form and concerns itself with the relationship between changes in internal Purchasing Power and the changes in exchange rates. Thus, the theory in its relative version states that the changes in the equilibrium rate of exchange will be governed by the changes in the ratio of their respective Purchasing Power. Here, some past exchange rates is assumed to be an equilibrium rate and is adopted as the base rate.

Date __/__/____ Page No.: 4

Criticisms Against The Purchasing Power Parity Theory:-

Following are the criticisms of Purchasing Power Parity theory:-

(1) It ignores many real determinants.
(2) It is based on unrealistic assumptions.
(3) It is an empty truism.
(4) The theory overlooks the influence of demand and supply factors in foreign exchange.
(5) The theory holds good in the long-run.
(6) It disregards the basis of international trade.
(7) The theory involves a practical difficulty of measuring the true purchasing power of a currency.
(8) The theory neglects capital transactions in international economic relations.
(9) It unrealistically assumes exchange rate to be a passive variable.
(10) The theory applies to a stationary world.
(11) It does not consider the significance of the elasticities of reciprocal demand.
(12) It fails to explain large volatility.

Although the theory has its drawbacks, it explains the working of a long-term tendency in exchange rates, which has an important bearing on practical policy in regard to foreign trade and payments. In recent research studies, empirical evidences tend to support some form of long-run purchasing power parity.