What is Purchasing Power Parity?

Worksheet

PPP is the law that the same basket of goods costs equal amounts in all countries when converted to a common currency at the appropriate exchange rate.

PPP = P_A/P_B

P_A = Price in Country A (local currency)
P_B = Price in Country B (local currency)

Questions

1. A pizza costs $10 in USA and €8 in Italy. PPP exchange rate?

A) 1.25 $/€
B) 0.8 $/€
C) 2 $/€
D) 0.5 $/€

2. PPP assumes all prices in different countries...

A) are identical
B) should equal when adjusted for exchange rates
C) never change
D) depend only on inflation

3. Why might PPP not hold in reality?

A) Exchange rates are always accurate
B) Transport costs, tariffs, and non-tradable goods create gaps
C) All countries produce the same goods
D) Inflation is zero everywhere

4. If PPP predicts 1.50/€1, but market rate is1.80/€1...

A) the euro is undervalued
B) the dollar is undervalued
C) PPP is always wrong
D) exchange rates don't matter

5. A coffee costs $4 in USA and £2.40 in UK. Find the PPP exchange rate.

6. A burger costs ₹500 in India and $12 in USA. What is PPP?

7. Monthly rent: ¥100,000 in Japan, $1,000 in USA. Calculate PPP rate.

8. Define: What is Purchasing Power Parity?

9. Define: What does PPP measure?

10. Define: Why is PPP important?

Answer Key

1. A) 1.25 $/€ — PPP = 10 ÷ €8 = 1.25/€. At this rate, goods cost the same in both countries.

2. B) should equal when adjusted for exchange rates — PPP states that identical goods should have equal purchasing power across countries when converted.

3. B) Transport costs, tariffs, and non-tradable goods create gaps — Real-world PPP deviations occur due to trade barriers, local services, and market inefficiencies.

4. B) the dollar is undervalued — Market rate is higher (1.80) than PPP (1.50), suggesting the euro is overvalued or dollar undervalued.

5. PPP = 4 ÷ £2.40 = 1.67 The PPP exchange rate is1.67 per £1

6. PPP = ₹500 ÷ $12 = 41.67 One dollar = ₹41.67 by PPP

7. PPP = ¥100,000 ÷ 1,000 = 100 PPP suggests ¥100 =1

8. A law stating identical goods cost the same in all countries when adjusted for exchange rates.

9. The exchange rate at which prices of identical baskets are equal across countries.

10. It helps compare living standards, inflation, and currency over/undervaluation between countries.