Determining Purchasing Power

A popular term amongst economists to determine the value of currencies and its purchasing power is a currency's "purchasing power parity" (PPP). Under this terminology, economists examine the long term exchange rate of two currencies to determine what equalizes their purchasing power. This is based on the theory that every good should have an identical market value. It also assumes the theory called "one price" which means that beyond outside influences like tariffs, taxes, shipping costs, etc., the product will have the same price regardless of location. This means that a Nike shoe in the U.S. should have the same value as the identical Nike shoe in England. The theory behind PPP is that it equalizes the purchasing power of different currencies.

Many economists use these adjustments to equalize what a specific item or service should cost based on a countries economy. It gives a clearer picture of a country's economy than by comparing their gross domestic product (GDP) using exchange rates. The reason why GDP does not give an accurate picture is that it doesn't take into account the differences between different countries income and money expended, it only takes into account the total income of the country.

The way the economists are able to determine the difference between economies is to examine the difference in price of like goods. An example would be a can of Coke in the U.S. will cost $1, while in England it would cost 1.50 pounds. This illustrates that PPP exchange rate is $1 = 1.5 pounds. However, in other areas the price may differ because the purchasing power of other currencies is not as strong. Thus, the currency may have different variables based on the purchasing power within different countries that use the same currency.

This formula also allows us to get an accurate picture about the value of other countries. An example is if the value of a currency falls by then their GDP will be reduced by as well. The reason for the reduction in value of the currency is because of international trade and financial markets. In reality though, by using the PPP we can see that this country is not any poorer because the income and products have remained the same. This is why the PPP is a more accurate way to determine the spending power and exchange rates amongst the currencies of the world.