

CHAPTER OVERVIEW

6: Purchasing Power Parity

Purchasing power parity is both a theory about exchange rate determination and a tool to make more accurate comparisons of data between countries. It is probably more important in its latter role since as a theory it performs pretty poorly. Its poor performance arises largely because its simple form depends on several assumptions that are not likely to hold in the real world and because the amount of foreign exchange activity due to importer and exporter demands is much less than the amount of activity due to investor demands. Nonetheless, the theory remains important to provide the background for its use as a tool for cross-country comparisons of income and wages, which is used by international organizations like the World Bank in presenting much of their international data.

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