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Purchasing Power Parity (PPP)

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Purchasing Power Parity (PPP)

Purchasing power parity (PPP) compares what money can buy in different countries.

It uses local prices for comparable goods and services. A market exchange rate answers a different question.



Currencies trade at market rates. PPP compares their buying power using local prices. Photo: Marek Ślusarczyk (Tupungato), CC BY 3.0, via Wikimedia Commons.

This lesson explains PPP, why it differs from market rates, and when to use each.

How did PPP grow from an idea to global price surveys?

Why compare prices?

One dollar buys different amounts in different countries. The “law of one price” says identical traded goods should tend towards one price after currency conversion. Transport costs, taxes, trade rules, and local services stop that from holding exactly.

Economists use this idea to compare whole price levels. A single good cannot represent an entire economy. That is why modern PPP work prices many goods and services.

How did the global PPP comparison develop?

The International Comparison Program (ICP) began in 1968. The World Bank now coordinates it under the United Nations Statistical Commission. Its benchmark rounds include 2011, 2017, and 2021.

The **2021 round covered 176 participating economies**. Its results were published in May 2024. Later annual figures may be estimates based on these price surveys. Never confuse a reference year with the publication year.

Sources: imf.org; worldbank.org

> **Quick check 1.** The ICP 2021 round measured prices in 2021 and published its results in 2024. True or false? *(True or False?)* See answer ↓

How does PPP work?

How PPP works

What is PPP, and how does a basket example show it?

PPP is a currency conversion rate based on equal buying power. The ICP compares national prices for similar baskets.

It also uses spending weights, because people do not buy every item equally often. **Simple example:** Assume a basket costs ₹200 in India and $10 in the United States. The basket PPP is ₹20 per international dollar.

Assume the market rate is ₹80 per US dollar. These are invented teaching numbers, not real survey results.

An economy with ₹8,000 of output equals **400 international dollars** at that basket PPP. The same ₹8,000 equals **$100** at the market rate. The larger PPP figure reflects cheaper local prices. It does not mean ₹8,000 can be exchanged for $400 at a bank.

Sources: worldbank.org

What is an international dollar?

An international dollar has the same buying power over gross domestic product (GDP) as one US dollar has in the United States.

It is a statistical unit, not a currency you can spend. **PPP conversion factor:** local currency units needed to buy the same basket that one US dollar buys in America.

For full GDP comparisons, the ICP uses many items and spending weights. It includes household purchases, government services, and investment goods.

PPP GDP asks about the volume of output at common prices. **PPP GDP per person** divides that total by population. A high total can coexist with much lower output per person.

Sources: worldbank.org; databank.worldbank.org

> **Quick check 2.** In the example, ₹8,000 becomes 400 international dollars at a ₹20 PPP factor. True or false? *(True or False?)* See answer ↓

How is PPP different from nominal GDP?

Why do PPP GDP and market-rate GDP differ?

Two ways to convert national output

Question	PPP GDP	Market-rate GDP
Conversion	Local price comparison	Foreign-exchange market rate
Best use	Compare real output and living standards	Compare dollar flows, trade, and foreign debt
Unit	International dollars	US dollars
Main caution	Price survey uncertainty	Currency movements affect rank

PPP and market-rate GDP answer different questions. A market-rate conversion matters when paying for imports or foreign debt. PPP better reflects the cost of local goods and services.

Sources: imf.org

Why does India look larger under PPP?

Many local services cost less in India than in high-income countries. Haircuts and local transport cannot easily be shipped across borders. Their prices often differ more than prices of traded goods. This helps explain the gap between India's PPP and market-rate GDP.

The World Bank's **2021 ICP benchmark** placed India third by PPP GDP, after China and the United States. It reported about **11 trillion international dollars** for India. This is a dated benchmark, not a current forecast or a per-person figure.

India's market-rate rank may differ and can change with exchange rates.

Sources: worldbank.org; databank.worldbank.org

> **Quick check 3.** PPP GDP and market-rate GDP answer exactly the same question. True or false? *(True or False?)* See answer ↓

What are the uses and limits of PPP?

What are absolute and relative PPP?

Absolute PPP compares price levels at one time. In the basket example, ₹20 and $1 buy the same items. **Relative PPP** concerns change over time. If prices rise faster in one country, its currency may tend to lose value over a long period.

This is a tendency, not a short-run exchange-rate forecast. Interest rates, capital flows, trade costs, and government policies can move currencies. Do not use an ICP PPP factor as proof that a currency is "overvalued" or "undervalued." The World Bank warns against that use.

Sources: worldbank.org; imf.org

What does the Big Mac Index show, and where does it fall short?

The Big Mac Index compares one burger's prices across countries. It makes the basket idea easy to see. It is **not** the World Bank's official PPP measure. One food item cannot represent homes, transport, health care, and investment goods.

Real baskets vary by country. Quality, taxes, and availability differ. National price surveys take time. The ICP estimates missing years and may revise earlier results. Services that cannot cross borders also challenge the simple law of one price.

A worker in a richer country may be more productive. Wages and local service prices can then be higher. Economists call this a Balassa–Samuelson effect. It helps explain why poorer countries often have lower overall price levels.

Sources: imf.org; worldbank.org; databank.worldbank.org

Think it through. Why can a country have high total PPP GDP but modest PPP GDP per person?

Total GDP is the sum of everyone's output. A large population can produce a large total. Dividing by the population gives a different comparison.

Why can't we just use the exchange rate?

The exchange rate shows what a currency buys in world markets. It does not show what it buys at home.

A haircut costs far less in India than in the US. The exchange rate hides this gap.

PPP fixes it by comparing the price of the same basket of goods in each country.

Who uses PPP numbers?

The World Bank and the IMF publish PPP figures. They use them to compare living standards.

PPP is also used to set poverty lines in international dollars.

Countries do not pay or trade at PPP rates. It is only a comparison tool.

What are the limits of PPP?

PPP depends on the basket chosen. A different basket gives a different answer.

Goods are not always alike across countries. Quality and services differ.

So PPP is an estimate. Use it for living standards, and use market rates for trade.

Why is a haircut cheaper in India than in the US?

Services use local labour. Wages in India are lower than in the US.

So a haircut costs less in rupees, even after converting to dollars.

PPP corrects for this by comparing what money buys in each place.

What is GDP at PPP?

It is a country's output counted at a common set of prices. The common price is in international dollars.

This shows the volume of goods and services more fairly. Nominal GDP shows value at market exchange rates.

PPP ranks India higher than the nominal figure does.

Who runs the global PPP comparisons?

The International Comparison Program collects prices in many countries. The World Bank leads it.

Statisticians compare the cost of the same goods and services in each country.

The results come out every few years.

Why does the World Bank use PPP for poverty lines?

A dollar buys more in poor countries. The poverty line must reflect that.

So the line is set in PPP dollars, not market dollars.

This makes poverty counts comparable across countries.

Which measure should you use in an answer?

Use PPP when you compare living standards or the size of real output.

Use market rates when you talk about trade, debt or foreign reserves. Those are paid in actual currency.

State which measure you mean in the first line of your answer.

Is PPP an exact measure?

PPP compares a basket of goods, but goods differ in quality across countries.

Some items, such as housing, are hard to compare fairly.

So PPP figures are estimates, not exact counts. They change when the basket is revised.

Previous Year Question

Exam practice

UPSC 2019: do not mix the measures

UPSC's 2019 paper asked whether PPP exchange rates compare prices of the same basket across countries.

It also claimed India was the world's sixth-largest economy in PPP dollars. **Only the basket statement was correct.** India's PPP rank was already higher than sixth. The error is to move a market-rate ranking into a PPP statement.

Read the linked 2019 question.

> **Quick check 4.** The 2019 UPSC question correctly called India sixth-largest in PPP GDP. True or false? *(True or False?)* See answer ↓

Current use: poverty and comparison

How does PPP help compare poverty?

The World Bank uses consumption PPPs to compare poverty across countries. In June 2025, it updated the international extreme-poverty line to **$3.00 per person per day in 2021 PPP dollars**. The older line was $2.15 in 2017 PPP dollars.

This change is not a simple $0.85 increase in cash. It also reflects new price comparisons and updated national poverty lines. A PPP poverty threshold should never be converted at the day's market exchange rate.

Sources: worldbank.org

Which measure should you pick, PPP or nominal?

Use PPP GDP to compare the real size of economies. Use PPP per person to compare average output or income. Use market exchange rates for cross-border payments. Use local survey data to study poverty within one country.

Neither PPP nor GDP alone measures inequality, unpaid care, or environmental damage. Check the year, unit, and whether a number is a survey result or an estimate.

Quick check 5. The World Bank uses PPP-adjusted dollars for its international poverty line. True or false? *(True or False?)* See answer ↓

Quick check 6. A PPP conversion factor proves a currency is overvalued in the foreign-exchange market. True or false? *(True or False?)* See answer ↓

Primary sources

- World Bank ICP methodology — baskets, prices, weights, and conversion.
- World Bank ICP data — the 2021 round and statistical cautions.
- World Bank 2021 comparison — India’s dated PPP rank.
- IMF explanation — PPP versus market exchange rates and Big Mac example.
- World Bank 2025 poverty update — 2021 PPP poverty line.

Practice MCQs

1. What does purchasing power parity (PPP) compare?

A. Only market exchange rates

B. Only a country's gold reserves

C. What money can buy in different countries

D. Only a country's tax rates

See answer ↓

2. Which body now coordinates the International Comparison Program (ICP)?

A. The WTO

B. The International Court of Justice

C. The Reserve Bank of India

D. The World Bank

See answer ↓

3. The ICP 2021 round published its results in which year?

A. 2021

B. 2024

C. 2011

D. 2017

See answer ↓

4. What is an international dollar?

A. A currency you can spend anywhere

B. A statistical unit with the buying power of one US dollar in the US

C. A coin issued by the IMF

D. Another name for the euro

See answer ↓

5. A basket costs ₹200 in India and $10 in the US. What is the basket PPP?

A. ₹20 per international dollar

B. ₹210 per dollar

C. ₹2,000 per dollar

D. ₹190 per dollar

See answer ↓

6. Why can PPP output look larger than output at market rates for a lower-price economy?

A. Local prices are lower, so money buys more

B. Banks pay a bonus on PPP

C. The country prints more money

D. Taxes are always zero there

See answer ↓

7. Which statement about the law of one price is correct?

A. It always holds exactly for every good

B. It applies only to services

C. It says exchange rates never change

D. Identical traded goods should tend toward one price, but costs and taxes stop it holding exactly

See answer ↓

Answer Key

1. **C.** PPP uses local prices to compare buying power. A market rate answers a different question. ↑ Q1
2. **D.** The World Bank coordinates the ICP under the United Nations Statistical Commission. ↑ Q2
3. **B.** The reference year was 2021. The results came out in May 2024. ↑ Q3
4. **B.** It is a statistical unit, not spendable money. ↑ Q4
5. **A.** ₹200 divided by $10 is ₹20. The numbers are only a teaching example. ↑ Q5
6. **A.** Cheaper local prices raise output measured at common prices. It is not a bank exchange value. ↑ Q6
7. **D.** Transport costs, taxes and trade rules break exact equality. ↑ Q7

Quick-check answers

1. **True.** The reference year and release year are different. The 2021 round covered 176 participating economies. ↑ 1
2. **True.** Divide ₹8,000 by ₹20. This is a teaching calculation, not a real national estimate. ↑ 2
3. **False.** PPP adjusts for local prices. Market rates value cross-border payments in traded currency. ↑ 3
4. **False.** The sixth-place claim was the trap. India ranked much higher by PPP. ↑ 4
5. **True.** Its June 2025 update set the line at $3.00 per day in 2021 PPP dollars. ↑ 5
6. **False.** The World Bank warns against using ICP PPPs as currency valuation signals. ↑ 6

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