

Question #65368, Economics / Economics of Enterprise

To what extent does PPP explain exchange rates? What is the relation between the two?

ANSWER: PPP is the level of exchange rate, which balances the consumption ability of each exchange rate. **According to the conception of PPP, international competition will bring to the balance of the domestic and abroad prices of the goods and services participating in the international trade.**

The situation when the level of inflation rate inside the country is higher than the outside inflation rate, the national currency will have a tendency of getting cheaper. The relation between PPP and exchange rate can be illustrated with help of the following formula:

$$\downarrow r = \frac{P_d}{P_f} \uparrow^1$$

where

r is the price of the abroad currency in terms of national currency, P_d –is level of domestic prices, P_f –is the level of foreign prices.

Therefore, the arrows show that the rise of $\frac{P_d}{P_f}$ ratio will bring to compensating decline of the level of exchange rate!

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