What Is Purchasing Power? Definition

Purchasing power refers to the value of a currency expressed in terms of the number of goods or services that a single unit of currency can buy.

Purchasing power is crucial, because all else being equal, inflation decreases how much goods or services you could buy.

In investment terms, purchasing power refers to the amount of credit available to a customer to buy more against what exists in the brokerage account.

> *Purchasing power may also be known as a currency's buying power.*

Understanding Purchasing Power

Inflation reduces a currency's value and thus purchasing power because it essentially increases prices.

To measure purchasing power in the traditional economic sense, compare the price of a good or service against a price index like the Consumer Price Index.

One way to think about purchasing power is to imagine if you made the same salary as your grandparents did 40 years ago.

Today, you need a much larger salary just to maintain the same quality of life.

A home buyer looking for a home a decade ago in the $300,000 to $350,000 price range had more options to consider then home buyers on the current market.

Consider, for instance, the value of $50 in 1959. What kind of purchasing power would it have had 60 years later in 2019?

According to the CPI inflation calculator, what cost $50 in January 1959 would cost $444.78 in January 2020.

If you were to buy the same products in 2020 and 1959, they would cost you $50 and $5.62 respectively.

Purchasing power affects every aspect of economics from the consumers buying goods to investors and stock prices to a country's economic prosperity.

When a current is purchasing power decreases as a result of excessive inflation, there are serious economic consequences such as the rising cost of goods and services that contribute to a High Cost of Living.

It also causes high-interest rates that affect the global market and following credit ratings. All of these factors can contribute to an economic crisis.

Because of this, a country's government institutes regulations and policies to protect a currency's purchasing power and keep the economy healthy. One way to monitor purchasing power is through the Consumer Price Index.

The US Bureau of Labor Statistics measures the weighted average price of consumer goods and services in particular transportation, medical care, and food.

The CPI is calculated by averaging these price changes and is used as a tool to measure changes in the cost of living and a marker for determining rates of inflation and deflation.

Consider for a moment that the United States has had a federal minimum wage of $7.25 per hour since July 24, 2009. 10 years later, in 2019, What would have cost $7.25 in 2009 now cost $8.86. The federal minimum wage has not kept up with inflation which is wreaking economic havoc.

Purchasing Power Loss and Gain

Power loss and gain is an increase or decrease and how much consumers can buy with a given amount of money.

Consumers lose purchasing power when prices increase in gain purchasing power when prices decrease.

Causes of purchasing power loss include government regulation, natural and man-made disasters, and inflation. The causes of purchase power gain include deflation and technological innovation.

Your Company Has Purchasing Power

In its most simple form, purchasing power is a measurement of how much your organization can buy with cash or credit. If you have $5,000 in cash and pre-approval for a $10,000 loan, then you have $15,000 of purchasing power.

When your company is large and has a lot of cash, it is likely to make large and ongoing purchases and therefore May more easily secure discounts from the vendors you work with.

Because of your company’s purchase power, you will be able to get better deals.

For instance, an organization the size of Apple can get better rates on health insurance plans than a small 10-person business because it has so many employees that even with a lower price per employee, the insurance company stands to make more money.

That’s because Apple can and will pay for multiple employee Insurance, their purchase power is huge.

Even if you are not a large company, you can earn more purchasing power with your vendors by consistently paying on time.

As your company grows and you can increase your order volume and or frequency, he may be able to leverage discounts based on that and increase your purchasing power.

Even if you don’t increase your order volume or frequency, simply paying your bills early or on time establishes a good rapport with your vendor and they may be willing to extend you credit or a discount on future orders so that you get more value from the same amount of money.

Purchasing Power Parity and International Vendors

You can use purchasing power parity (PPP) to level currencies. You can use it to compare values in different currencies with a common platform.

For instance, with July 2010 currency rates, if a Japanese art buyer has 43,881,512 yen to spend in an auction and a French buyer has 384,961 Euro, they both have $500,000 a purchasing power.

Purchasing power parity ensures that you are getting the value you’re looking for once your currency has been exchanged to another one.

It does not matter which currency is used as the common denominator, but to determine the purchasing power, alternate currencies need to be compared via the same currency.

Say you want to buy five items from a vendor based in China, but a vendor based in Ireland has the same five items for sale.

All other things being equal – shipping times and costs, lead times, etc. you’d use PPP to convert both costs in Yuan and Euro.

If the price is 7,023.40 Chinese Yuan ($1,000) and 880.49 Euro ($950), then the Irish vendor is the one who provides a better price, so you get a higher value of money.

When calculating the PPP across vendors in different companies, make sure you are using the exact same basket of goods to get an accurate picture of the purchasing power of money.

Because of inflation, the purchasing power of US dollars, along with other currencies across the globe changes on a regular basis.

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