

3. Market Imperfections: Multinational corporations and price discrimination reduce the effectiveness of PPP.

Example:

Microsoft Office being sold in the United States and China. The version sold in China is priced significantly lower than the version sold in the U.S., primarily because it is customized with Chinese characters and designed for the local market. According to PPP theory, arbitrage should drive prices to equalize.

The Chinese version of Microsoft Office is tailored specifically to Chinese users. Few American consumers would want or be able to use a version that is not in English. As a result, the law of one price does not apply to this product, even though transportation costs are minimal and there are no significant trade barriers like tariffs between the two countries.

FIXED VS. FLOATING RATES: The Case for Floating Rates

Fixed interest rates remain constant throughout the life of a loan or investment, providing predictable monthly payments. Floating interest rates, also known as adjustable or variable rates, change periodically based on a benchmark index like LIBOR or the prime rate.

[The "case for floating rates" argues that in a rising interest rate environment, floating rates offer several advantages:

- Higher Yield Potential
- Protection Against Rising Rates
- Low Duration
- Low Correlation

While floating rates offer these benefits, investors should carefully consider their individual risk tolerance and investment goals before making any decisions.

INTEREST RATES & EXCHANGE RATES

Interest rates - represent the cost of borrowing money or the return earned on savings.

Two Main types of Interest Rate

1. **Nominal interest rate:** The stated rate, which includes both the real rate of return and expected inflation.
2. **Real interest rate:** The return on investment or the cost of borrowing, adjusted for inflation, which reflects the true purchasing power of money.

Economic theory suggests that interest rates are influenced by anticipated future inflation rates. This economic theory is the **Fisher Effect** which was proposed by **Irving Fisher**. It explains the

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