#### Chapter 25

#### Terms of trade

#### **Key terms**

1. Terms of trade: the ration of export prices to import prices

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Formula terms of trade = <u>Index of export prices</u> x 100 Index of import prices

#### 2. Factors influencing the terms of trade

The terms of trade for a country, the ratio of average export to import prices, can change for a variety of reasons :

- **2.1 Relative higher inflation rates** => Terms of trade improved
- **2.2 Relative higher productivity rates =>** Price of export is relatively lower => Terms of trade worsen.
- **2.3 Relative lower labour costs =>** Price of export is relatively lower => Terms of trade worsen.
- **2.4 Exchange rate falls =>** Price of export is relatively lower => Terms of trade worsen.
- **2.5 A rise in commodity prices** => world market price of oil rises => It a country exports oil => Terms of trade improved
- **2.6 Changing incomes =>** world income rises => It rises price of tourism => Terms of trade improved for a country depending on traveling industry.

# 3. Effects of changes in the terms of trade on export revenues and the balance of trade

#### 3.1 Exports are price elastic

Terms of trade improved => Price of export rises => export revenue falls.

#### 3.2 Exports are price inelastic

Terms of trade improved => Price of export rises => export revenue rises.

#### 3.3 Imports are price elastic

Terms of trade improved => Price of imports falls => import expenses rises

#### 3.4 Imports are price inelastic

Terms of trade improved => Price of imports falls => import expenses falls

# 4. Effects of changes in the teams of trade on the domestic economy TOT improved (price of export is relatively higher than imports) Advantages of TOT improved

- 1) Improving TOT means an economy can import more goods for a unit of export.
- 2) If demand for export and import are price inelastic, improving TOT can improve trade balance.
- 3) Improving TOT means price of imported raw material falls then it can reduce cost push inflation.

## Disadvantages of TOT improved

1) If demand for export and import are price elastic, improving TOT can worsen trade balance. Also it can reduce economic growth and employment

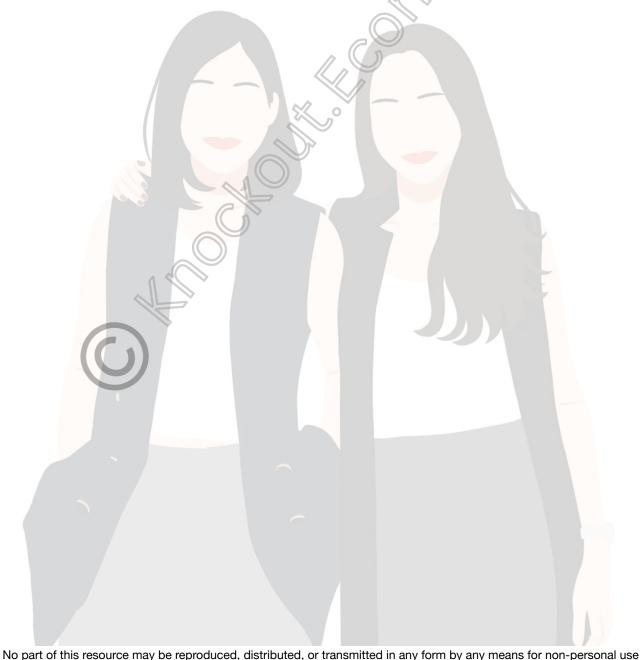
### **Exercise Chapter 25**

# **Terms of trade**

 Between 2000 and 2013, Bangladesh's terms of trade worsened by around 43% while Norway's terms of trade improved by around 60%

(A) Assess the factors that can cause a change in a country's terms of trade. (15 marks)

(B) Evaluate the effects of a worsening of a country's terms of trade on a government's macroeconomic objectives. (25 marks)



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