Chapter 25

Terms of trade

Key terms

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

1. Terms of trade

- Terms of trade: the ration of export prices to import prices

$$\textbf{Formula terms of trade} = \frac{\textbf{Index of export prices}}{\textbf{Index of import prices}} \times 100$$

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

1. 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)