
The terms of trade

Chapter 63 – February, 2017

CALCULATING THE TERMS OF TRADE

$$\text{index of terms of trade} = \frac{\text{index of export prices}}{\text{index of import prices}} \times 100$$

- ▶ terms of trade *improves*: means the value of the index *increases*
- ▶ terms of trade *deteriorates*: means the value of the index *decreases*
- ▶ Question 1 (5 minutes)

FACTORS INFLUENCING THE TERMS OF TRADE

▶ **short run**

- ▶ change in *exchange rate* → changes import and export prices
- ▶ change in *inflation* → relative inflation between local and foreign economy
- ▶ change in *demand* for imports/exports → change in prices

▶ **long run**

- ▶ change in *productivity* → affects the prices through the cost of production
- ▶ change in *incomes* → affects the pattern of demand

EFFECTS ON THE BALANCE OF PAYMENTS

ELASTICITIES OF DEMAND FOR EXPORTS

- ▶ *exports are price elastic:*
 - ▶ export prices \uparrow \rightarrow quantity of exports \downarrow \rightarrow total value ($P \times Q$) of exports \downarrow
 - ▶ export prices \uparrow \rightarrow \uparrow terms of trade \rightarrow *deterioration* in current account on balance of payments
- ▶ *exports are price inelastic:*
 - ▶ export prices \uparrow \rightarrow quantity of exports \downarrow (but less than proportional) \rightarrow total value ($P \times Q$) of exports \uparrow
 - ▶ export prices \uparrow \rightarrow \uparrow terms of trade \rightarrow *improvement* in current account on balance of payments

EFFECTS ON THE BALANCE OF PAYMENTS

ELASTICITIES OF DEMAND FOR IMPORTS

- ▶ *imports are price elastic:*
 - ▶ import prices \uparrow \rightarrow quantity of imports \downarrow \rightarrow total value ($P \times Q$) of imports \downarrow
 - ▶ import prices \uparrow \rightarrow \downarrow terms of trade \rightarrow *improvement* in current account on balance of payments
- ▶ *imports are price inelastic:*
 - ▶ import prices \uparrow \rightarrow quantity of imports \downarrow (less than proportionate) \rightarrow total value ($P \times Q$) of imports \uparrow
 - ▶ import prices \uparrow \rightarrow \downarrow terms of trade \rightarrow *deterioration* in current account on balance of payments

CHANGES IN EXPORT AND IMPORT PRICES

REASONS

- ▶ rise in the *prices of commodity products* (i.e., copper, wheat)
 - ▶ commodities tend to be price inelastic
 - ▶ improvement of terms of trade and current account balances
- ▶ rise in domestic inflation (→ rise in export prices)
 - ▶ terms of trade will improve (if import prices remain the same)
 - ▶ impact on current account balance will depend on elasticities

EFFECTS OF CHANGES IN THE TERMS OF TRADE

DOMESTIC ECONOMY

- ▶ *improvement* in the terms of trade (caused by rise in export prices) → GDP ↓ and unemployment ↑
- ▶ *improvement* in the terms of trade (caused by fall in import prices) → inflation ↓ and GDP ↓ and unemployment ↑