**Terms of Trade**

* ***The difference between the terms of trade and the balance of trade.***
* ***Calculation of the terms of trade.***
* ***Causes of changes in a country’s terms of trade in the short-run and long-run.***

In 1960, developing nation A had to sell **50** tonnes of grain to buy an imported tractor. In 2000 the same developing nation had to sell **200** tonnes of grain to buy the same tractor. The nation is said to have experienced a deterioration in its terms of trade.

1. What is the difference between the ***balance of trade*** and a nation’s ***terms of trade***?

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1. Terms of Trade is officially defined as the following :-

*Index of terms of trade = Weighted Index of average export prices x 100*

###  *Weighted Index of average import prices*

1. If import prices **rise** and export prices **fall** then we say there has been a **worsening** of the terms of trade.  Why is this the case?

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1. If import prices fall and export prices rise we say there has been an **improvement** in the terms of trade. Why is this case?

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5. Look at the export/import price statistics below

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Year** | **Index of average export prices** | **Index of average import prices** | **Calculation** | **Terms of Trade** |
| **1** | **100** | **100** |  |  |
| **2** | **104** | **101** |  |  |
| **3** | **105** | **107** |  |  |
| **4** | **111** | **111** |  |  |
| **5** | **107** | **109** |  |  |
| **6** | **105** | **109** |  |  |

* Describe what is happening to the terms of trade of the nation between year 1 and year 6.

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If the terms of trade improve, a given quantity of exports will buy more imports. Conversely, if the price of a basket of exports falls, then a country will need to sell more exports in order to keep imports at the same level.

**Causes** of Changes in a country’s terms of trade

The causes of a change in a country’s terms of trade can be divided into short and long term.

**Short term**

1. Illustrate and explain how **demand and supply conditions** for exports may lead to a change in a nation’s terms of trade.

Price

Qty demanded/supplied

Price

Qty demanded/supplied

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1. What will happen to the **terms of trade** of **Nation A** if its domestic **rate of inflation** exceeds that of its trading partners?

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3. Illustrate and explain how a change in the **exchange rate** of **Nation A** can lead to a **deterioration** of its terms of trade.

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$ price of Pesos

 Qty of Pesos traded

**Long term**

5. What impact will **rising incomes** in the developed world have on the prices of some of the manufactured products and services that are mainly produced in the richer nations (MEDCs)?

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Price

level

 Real GDP

6. What impact will this have on the terms of trade of developing nations who produce a greater proportion of primary sector goods (LEDCs)?

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7. What will happen to the **price of a nation’s exports** if there are long-run improvements in productivity/technological developments within the country and thus the terms of trade?

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**Consequences** of Changes in a country’s terms of trade

An improvement or deterioration in a nation’s terms of trade can have positive or negative consequences.

Complete the table below to summarise this.

|  |  |  |
| --- | --- | --- |
| **Change in a nations terms of trade** | Cause | Positive/Negative |
| **Deterioration** | 1 - Depreciation/Deval. | Positive – PEDx + PEDm > 1  |
|  | 2 – Productivity increase | Depends |
|  | 3 – Lower inflation than.. | Depends |
|  | 4 – Falling incomes | Negative |
| **Improvement** | 1 – Appreciation | Depends |
|  | 2 – Fall in supply | Depends |
|  | 3 – Higher inflation than.. | Depends |
|  | 4 – Rising incomes | Positive |

1. Write down the formula for the price elasticity of demand for exports below.

% change in qty demanded of exports x 100

% change in average price of exports

* In order for a **fall in the average price of exports (assuming a constant exchange rate)** to lead to an increase in export revenue, then price elasticity of demand for exports would have to exceed \_\_\_\_\_\_\_\_\_\_\_\_\_\_.

**However,** if the LEDC is receiving payment for its exports in the foreign currency (e.g. the dollar), then demand for exports will have to be price elastic in order for revenue to increase following a devaluation.

9. Would you say that demand for the exports of developing nations such as copper, coffee and cotton is price elastic or inelastic?

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10. Write the formula for the **price elasticity of demand** for imports.

% change in qty demanded of imports x 100

% change in average price of imports

* If import prices are rising (assuming a constant exchange rate), what would be the impact of a less than proportionate fall in their demand?

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**Improvement in the Terms of Trade (beneficial?)**

The impact of an improvement in the terms of trade depends upon the reason for the improvement.

12. There is an **increase in demand for the exports** of **Nation A due to:-**

*
*

13. Illustrate this on the diagram below:-

Average Export Price

 Quantity of Exports

14. An improvement in the terms of trade that is caused by an increase in demand for exports leads to:-

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

15. Why might there be an improvement in the terms of trade if nation A is experiencing **higher inflation** than the countries with which it trades?

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16. Will this improvement in the terms of trade lead to an improvement in the current account position of nation A?

* Look at the diagram below.



17. What happens to the price elasticity of demand as the price falls?

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18. Using the diagram above explain under what circumstances will an **improvement** in the terms of trade (**caused by inflation**) lead to an **improvement** in the current account of the balance of payments?

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19. When will an **improvement** in the terms of trade of a nation caused by a **left shift in the supply** of exports lead to an **improvement** in the current account?

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20. When will an **improvement** in the terms of trade, caused by a **currency appreciation**, lead to an i**mprovement** in the current account position of a nation?

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

**Deteriorating terms of trade and LEDCs**

21. In this section we will be focusing on the impact of a deterioration in the terms of trade for developing nations that rely on non-oil exports (commodities).

* In the table below, summarize the reasons why there has been a fall in the prices of commodities.

|  |  |
| --- | --- |
| Reason | Explanation |
| Global Supply |  |
| Synthetic substitutes |  |
| Income elasticity of demand |  |
| Agricultural Policies |  |
| Technology |  |

21. Take two of the above reasons and use a demand and supply diagram to illustrate the impact on the market price of the commodity.

Price

Qty demanded/supplied

Price

Qty demanded/supplied

22. What is the impact on the **current account** of commodity dependent LEDCs when their **terms of trade deteriorate?**

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23. Explain why this is the case in terms of price elasticity of demand.

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24. Is **demand for imports** in developing nations likely to be **price elastic or inelastic** and why?

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25. As the price of imports rises relative to the price of exports, what is likely to happen to import expenditure?

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26. What are the **consequences** of a deteriorating terms of trade for developing nations that depend upon commodities?



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28. \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_



29. \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_



29. What do you notice about the prices of primary commodities in general?

**1995-2001**

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**2001-2006**

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30. Can you explain this movement?

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Price

level

 Real GDP

24. What does the data indicate about the nature of commodity prices?

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_