

Syllabus Reference 4.8: **Terms of Trade**

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THE TERMS OF TRADE

By terms of trade we mean the ratio between the average price of exports and the average price of imports. It may be expressed as the index number showing average price exports, divided by the index number showing average price, imports.

The terms of trade - the quantity of exports that have to be sold per unit of imports



Exam Focus:
M09/3/ECONO/HP2

5. Explain **two** economic consequences of a favourable movement in the terms of trade resulting from an increase in demand for a country's exports.

The terms are high or favourable when the average price of exports exceeds the average price of imports

Formula

The terms of trade are low or unfavourable when average import prices exceed average export prices

Index no. showing average price of exports **X**

Index no. showing average price of imports **M**

Multiply answer by 100 to get a percentage

Example:

(1963 = base year or 100)

1980 Terms of trade = 85

1981 Unit value index

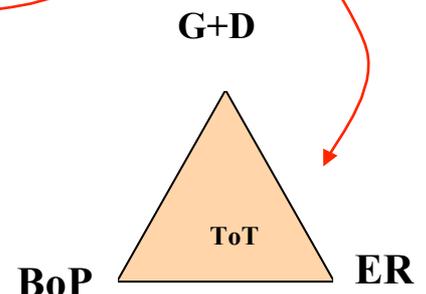
Imports = 232.4 Exports = 210.3

210.3 divided by 232.4 x 100 = Terms of Trade = 90.5 for 1981

Exam Focus: 2007 May HL 1

Q3 (A) Explain the likely consequences of a deterioration in the terms of trade for a country's balance of payments on current account.

Q3 (B) Evaluate the view that a deterioration in the terms of trade is the most significant barrier to economic development that a developing country can face in the area of international trade.



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Points to Note:

1. Whether the above terms are becoming more or less favourable depends on the figures for 1979 and 1980. If the figures for 1980 were lower than those for 1981 we may say of imports that the terms of trade are becoming more favourable. When the figure for the terms of trade is below **100**, we may say that the average price of imports is the higher and when it exceeds 100 the average price of exports is higher. As the figure for the terms of trade increases, we may say that the terms are moving in our favour, and as the figure become smaller, the terms are moving against us.
2. In the example we see the terms of trade becoming more favourable, as we move from 1980 to 1981. This means that, in 1981, we were able to buy a greater quantity of imports with our exports. This would appear to be very beneficial for the economy, but watch for danger signal-. the increase in the average price of exports can be due to increases in costs (i.e. domestic inflation), or it could be simply an increased demand for exports maybe as a result of a rise in incomes in the trading partner.
3. Changes in exchange rates will affect the terms of trade and must therefore be taken into account e.g. a lowering of the exchange rate – depreciation or devaluation will make exports cheaper and imports more expensive pushing the terms of trade downwards
4. Remember that these Macro statistics are indicators for government. The reasons behind the changes must be closely examined.
5. LDC'S are likely to have low terms of trade due to their reliance on one or two exports. If they overproduce, or if there is a drop in export earnings because of price inelasticity of demand (price fall) the average price of their exports will drop while the while the price of imported goods from developed countries is likely to remain high.
See Section 5.

Exam Focus: 2005 May HL 1

3. (a) Describe the factors which might cause a change in a country's terms of trade. [10 marks]
(b) Evaluate the significance for less developed countries of a deterioration in the terms of trade. [15 marks]