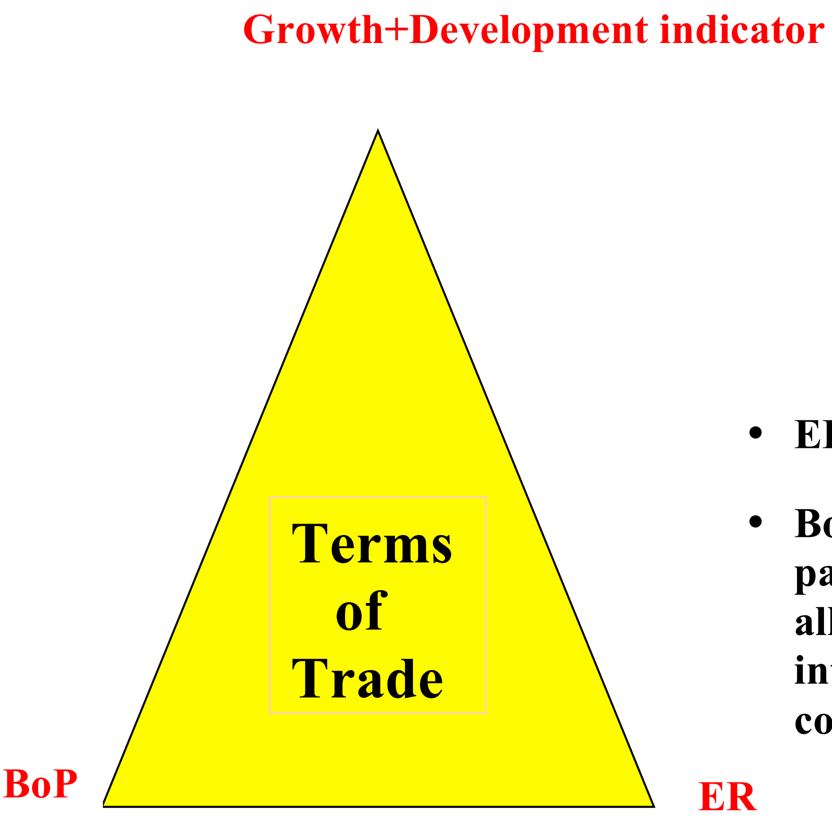
Webnote 351



- **ER= exchangre rates**
- **BoP = balance of payments; record of all flows of money into and out of a country.**

Terms of trade formula →

$$\frac{x}{m} \times 100$$

Exam Focus:

- HP 3: see the link to HP3 revision page and you will find a link to a Terms of Trade question
- HP2: you can be asked to define or explain why Terms of Trade are important

Syllabus Reference 3.5: *Terms of Trade*

http://economics.isdedu.de

THE TERMS OF TRADE: the formula

Example: measure terms of trade from 1980 to 1981

(1963 = base year or 100)

1. **1980 Terms of trade = 85**
2. **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.

The Terms of trade are improving and export prices are rising in relation to import prices.

See notes on page 3 to understand significant of improving 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 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

The terms are high or favourable when the average price of exports is rising in relation to the price of imports

Formula

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

$$\frac{\text{Index no. showing average price of exports} \quad X}{\text{Index no. showing average price of imports} \quad M}$$

Multiply answer by 100 to get a percentage

WHY? are terms of trade are important

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. Falling terms of trade send a bad signal for the economy as export prices may be falling while import prices may be rising. The injection X is falling while the leakage M can be rising. This is contractionary and can be nicely shown on the macroeconomic circular flow of income.
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.
6. Look at the Video from PAJ on Greek lemon exports. This is an excellent example of why export prices are important to small farmers and changes here can have a significant impact on the level of development in an economy expecially if export prices are falling and import prices are rising resulting in increased poverty for small farmers.