GLOBAL ECONOMICS

Terms of trade

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Terms of trade

A country's *terms of trade* measures a country's export prices in relation to its import prices, and is expressed as:

$$\frac{\text{Index of Export Prices}}{\text{Index of Import Prices}} \quad \text{X} \quad 100$$

For example, if, over a given period, the index of export prices rises by 10% and the index of import prices rises by 5%, the terms of trade are:

110 x 100 / 105

= 104.8

This means that the terms of trade have improved by 4.8%.

When the terms of trade rise above 100 they are said to be *improving* and when they fall below 100 they are said to be *worsening*.

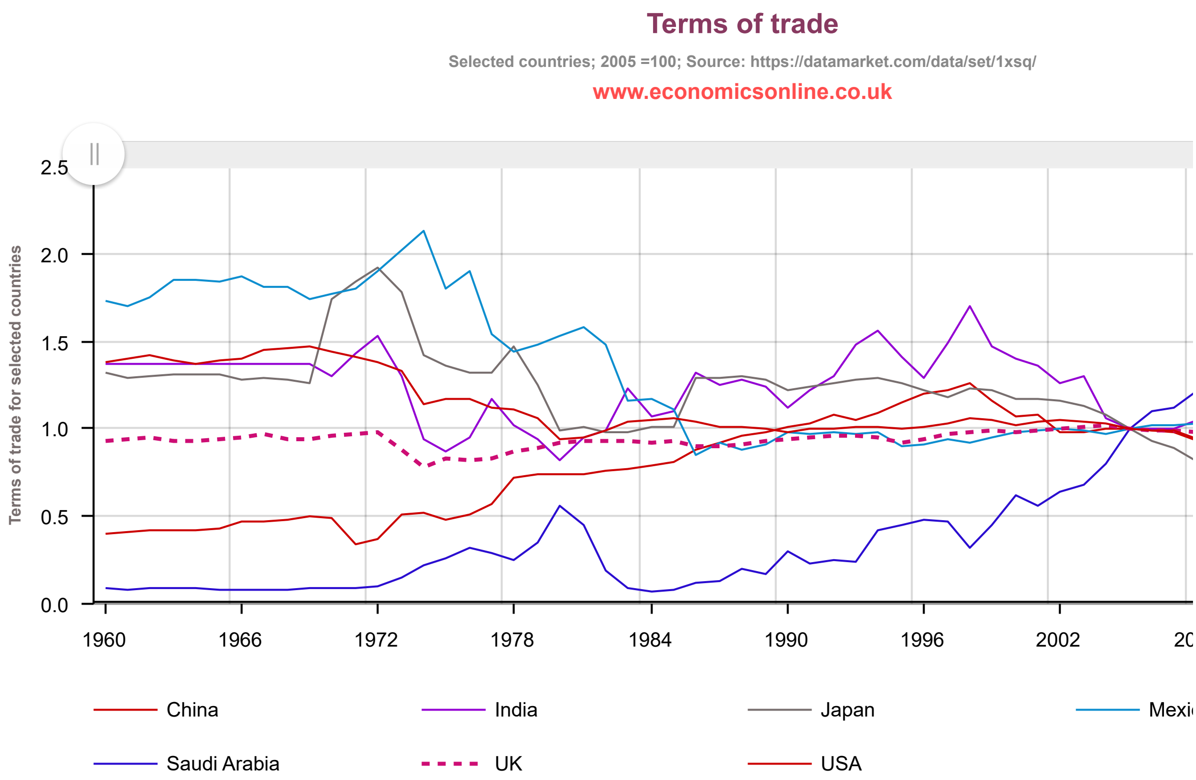
The terms of trade can also be expressed in terms of the number 1, with figures above 1 indicating an improvement, and those below 1 a worsening. This is shown in the chart below.

Improving terms of trade

If a country's terms of trade improve, it means that for every unit of exports sold it can buy more units of imported goods. So potentially, a rise in the terms of trade creates a benefit in terms of how many goods need to be exported to buy a given amount of imports. It can also have a beneficial effect on domestic **cost-push inflation** as an improvement indicates falling import prices relative to export prices.

However, countries may suffer in terms of falling export volumes and a worsening balance of payments.

Terms of trade



The UK's terms of trade have generally improved over the last 20 years, indicating that exports price have has been rising relative to import prices. This is partly caused by the fact that **globalisation** has tended to have less impact on the export price of UK *invisibles*, in comparison to its effect on the price of its *visible* imports.

The danger of an improving terms of trade is that it can worsen the **balance of trade** if UK and overseas consumers are **elastic** in their response to the relative export and import price changes.

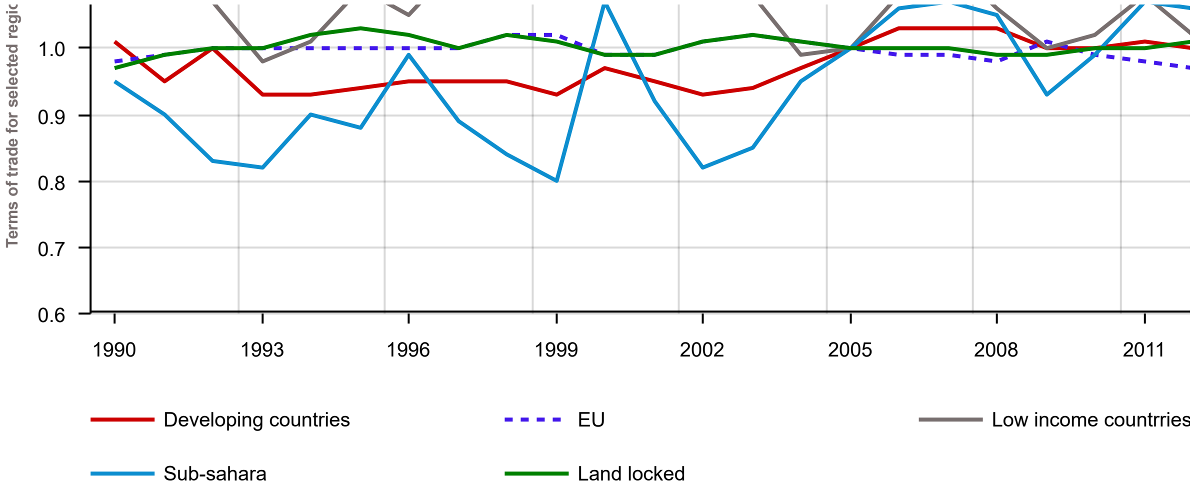
Worsening terms of trade

A worsening terms of trade indicates that a country has to export more to purchase a given quantity of imports. According to the **Prebisch-Singer hypothesis**, this fate has befallen many developing countries given the general decline in commodity prices in relation to the price of manufactured goods. However, **globalisation** has tended to reduce the price of manufactured goods over the past 15 years, so the advantage that industrialised countries had over developing countries may be falling.

The impact of globalisation has tended to halt the decline in the terms of trade of developing economies.

Terms of trade - Selected regions

Selected countries; 2005 =100; Source: https://datamarket.com/data/set/1xsq/



The terms of trade for the EU has fallen relative to developing countries since the financial crisis of 2009.

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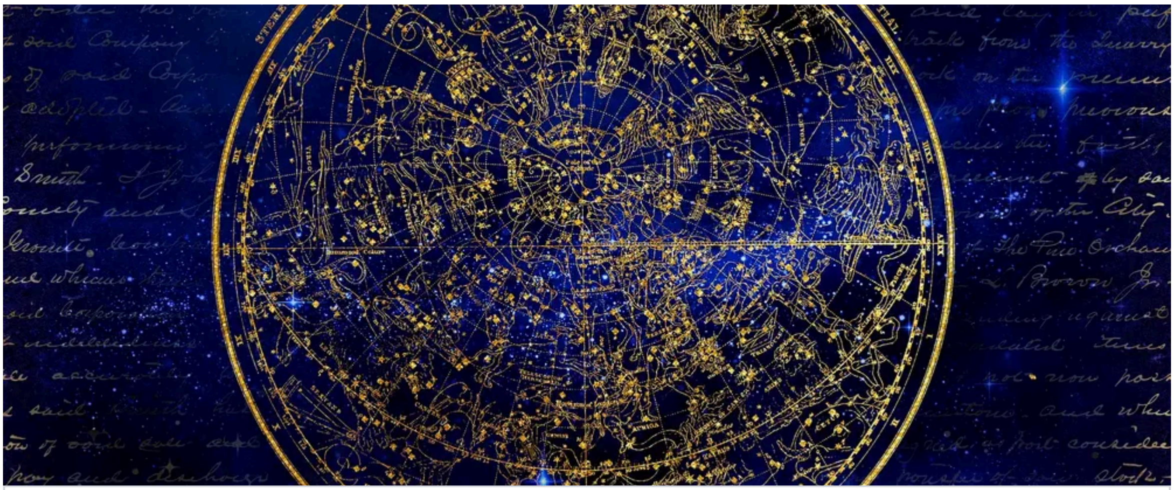

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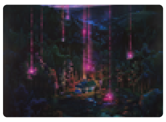

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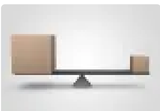

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