FACTORS INFLUENCING TERMS OF TRADE (ToT)[i]

1. **Elasticity of Demand:** Elasticity of demand measures how sensitive the quantity demanded is to changes in price. When the demand for a country's **exports** is **less elastic** compared to its imports, the TT tends to be **favorable**. In this case, export prices can increase without significantly reducing demand, thus improving revenue. Conversely, if the demand for **imports** is **less elastic** than exports, the ToT will become **unfavorable** because higher import prices will not reduce the import quantity significantly, leading to higher expenditure.

2. **Elasticity of Supply:** Elasticity of supply refers to how much the quantity supplied responds to changes in price. If the supply of a country's exports is **more elastic** than its imports, the ToT will be **favorable**. This is because an increase in export prices can lead to a proportionate increase in export revenue. If export supply is less elastic, the country may not benefit much from higher prices, leading to an unfavorable ToT.

3. **Nature of Goods**

Primary Goods vs. Manufactured Goods: Countries that primarily export raw materials or primary goods often face **unfavorable ToT**. This is because primary goods usually have volatile prices and less value-added. On the other hand, countries that export manufactured, or high-value-added goods tend to enjoy **favorable ToT** as these goods command higher and more stable prices.

Necessary Commodities vs. Luxury commodities:

A. ***Necessary Commodities (Relatively Inelastic Demand)***

   a. **Price Increase:** When prices of necessary goods rise, the inelastic demand ensures that the quantity demanded decreases only slightly, resulting in stable export revenues. This could lead to **favorable ToT** for the exporting country.

   b. **Price Decrease:** When prices fall, the inelastic nature of demand means that the increase in quantity demanded is relatively small, so the export revenue may drop. This could result in **unfavorable ToT**, as the gains from increased quantity are outweighed by lower prices.

B. ***Luxury Goods (Relatively Elastic Demand):***

a. **Price Increase:** As luxury goods have elastic demand, a price increase could cause a disproportionate decrease in quantity demanded. This may reduce export revenue and lead to **unfavorable ToT**.

b. **Price Decrease:** When prices fall, the elastic demand leads to a significant increase in quantity demanded, potentially boosting export revenue. This could result in **favorable ToT**.

4. Economic Development

Economic development affects the ToT through two distinct effects:

A. ***Demand Effect:*** As economic development raises income levels, the demand for imports often increases, which can worsen the ToT if import prices rise faster than export prices.

B. ***Supply Effect:*** Development can also lead to increased production of import substitutes and export. This reduces reliance on imports and can improve the ToT by decreasing import demand.

C. ***Net Effect:*** The overall impact of economic development on ToT depends on the relative strength of these two effects.

5. **Rate of Exchange:** The **rate of exchange** is the value of one country's currency relative to another's. It plays a critical role in determining a country's trade dynamics, including its terms of trade. The ToT measures the ratio of export prices to import prices, reflecting the purchasing power of exports in terms of imports. Exchange rate fluctuations can significantly impact this ratio.

A. ***Impact of Currency Appreciation on ToT*****:** Currency appreciation occurs when the value of a country's currency rises relative to others. For example, if the Indian rupee (INR) appreciates, it means one INR can buy more foreign currency than before.

i. **Effect on Export Prices:** With an appreciated currency, goods and services exported from the country become more expensive for foreign buyers. Export prices in foreign currency terms rise. However, this could reduce the quantity demanded for exports if demand is elastic. If demand is inelastic, export revenue might still increase, improving ToT.

ii. **Effect on Import Prices:** An appreciated currency lowers the cost of imports since foreign goods and services become cheaper in terms of the local currency. This reduction in import prices means the country can import more for the same expenditure, further improving ToT.

iii. **Net Effect*:*** The combination of higher export revenue and lower import costs typically leads to **favorable ToT**, as the country gains more value from its trade.

B. *Impact of Currency Depreciation on ToT*: Currency depreciation occurs when the value of a country's currency falls relative to others. For example, if the Indian rupee depreciates, it means more rupees are needed to purchase one unit of a foreign currency.

i. ***Effect on Export Prices:*** With a depreciated currency, the country's exports become cheaper for foreign buyers. Export prices in foreign currency terms fall, making them more competitive globally. This could increase the quantity of exports. However, if the additional volume of exports does not compensate for the lower prices, export revenue may decline, worsening ToT.

ii. ***Effect on Import Prices:*** A depreciated currency makes imports more expensive because the country now needs more local currency to buy the same amount of foreign goods and services. Higher import prices increase the cost of importing, potentially leading to higher expenditures on imports.

iii. ***Net Effect:*** The increase in import costs and potential decline in export revenue typically results in **unfavorable ToT**, as the country gets less value from its trade.

6. **Tariff Policy:** Tariffs are taxes on imports, and quotas are limits on the quantity of imports allowed. Imposing tariffs and quotas can restrict imports and thereby improve ToT, provided other countries do not retaliate with similar measures. However, if trading partners impose reciprocal tariffs, the net effect may neutralize or even worsen the ToT.

7. **Size of Population**

A. ***Overpopulated Countries****:* Larger populations often lead to higher demand for imports, which can cause an **unfavorable ToT** due to increased import prices.

B. Underpopulated or Optimally Populated Countries*:* These countries typically have more balanced import demand, leading to more favorable **favorable ToT**.

8. Size of the Country

A. ***Larger Countries:*** Larger countries often experience less favorable ToT because they may not fully benefit from economies of scale in global trade.

B. ***Smaller Countries:*** Smaller countries often enjoy relatively favorable ToT, as they can specialize in niche markets and leverage economies of scale from larger trading partners.

i. **Specialization in Niche Markets**: Limited resources push smaller nations to focus on high-value goods or services, building strong brand reputations and commanding premium export prices (e.g., Swiss watches or Singapore's financial services) which can earn increasing and stable export revenue leading to favourable ToT.

ii. **Leverage from Larger Partners**: Trade agreements with larger economies provide access to expansive markets and cost-effective imports, improving ToT by balancing high export values with competitive import costs.

9. Degree of Competition

A. ***Monopoly Power:*** A country that has monopoly power in exporting specific goods can dictate higher prices, leading to favorable ToT. If there are many alternative sources for the imports it requires, the country's bargaining position strengthens further.

B. ***Highly Competitive Markets:*** In highly competitive export markets, countries may struggle to command premium prices, resulting in less favorable ToT.

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[i] International Economic Cooperation (Unit I)