CLASS 11 TERMS OF TRADE

[PART 2]

Income Terms of Trade(ITT)

- Given by Dorrance as an improvement over the NBTT
- It refers to the ratio between the **value of exports** and the import prices.
- >> The ITT indicate the nation's capacity to import because PXQx/ Pm ,determines the volume of imports(Qm) that a country can obtain with the export earnings.

However this ITT has 2 major drawbacks:

- 1. It indicate only the export based capacity to import and not the country's total capacity to import, which in turn depends upon many other factors like the capital inflow, receipts from invisibles, unilateral payments etc.

- 2. A change in the ITT need not necessarily reflect the real gains from trade. **Even when export prices fall** and import prices remain constant , the ITT will improve, if the physical volume of exports increases more than in proportion to the fall in export prices.

Factoral TOT

- >> It considers the changes in productivity in the production of exports goods of the two countries. It may be :
- 1. Single Factoral TOT or
- 2. Double Factoral TOT

1. Single Factoral TOT

- It is the NBTT adjusted for the changes in the productivity of a country's factors in its export industries.
- It measures >> how much quantity of imports can be obtained per unit of its factor-inputs used in the production of the exportables.

- **So SFTT = NBTT * Zx**
- **Zx = Export Productivity Index**
- A rise in the SFTT implies that a greater quantity of imports can be obtained per unit of factor-input used in the production of exportables.

Thus the export productivity index can have highly significant effect on the terms of trade of a country.

- If the increase in productivity in the export sector causes such a substantial decline in costs that export prices have declined by a marked extent, **it is possible that the commodity terms of trade become unfavourable even when the single factoral terms of trade have improved.**

- From the point of view of a developing country, where the process of growth involves the use of improved techniques of production, the single factoral terms of trade are more representative and scientific compared with the commodity terms of trade.

Criticisms:

This measure of terms of trade is, however, criticised on the following main grounds:

- **(i) Difficulty in the Measurement of Productivity:**
- **The exact measurement of productivity and changes therein is quite difficult,** as factor productivity depends upon some non-quantifiable psychological and technical factors. The productivity of a factor unit differs not only from one export industry to another but also from one plant to another. That causes serious complication in the computation of productivity index and changes in it over different periods.
- **(ii) Not a Reliable Index of Gain from Trade:**
- The terms of trade are supposed to be an index of gains from international trade of a country. It is possible that increase in productivity index makes the single factoral terms of trade favourable but the rise in productivity in export sector and consequent fall in production costs **and export price index can transfer the gain from higher productivity and trade to the foreign country.** The productivity increase may occur in the exporting country but the productivity and trade gains go to the importing country.

(iii) Increase in Global Inequalities:

- The increased productivity in the export sectors of the advanced countries like U.S.A., Japan and the West European countries has brought about considerable improvement in their single factoral terms of trade while keeping their net barter terms of trade also favourable for them. However, the improvement in productivity in the export sectors in the LDC's has made both commodity terms of trade and single factoral terms of trade unfavourable.
- This has happened because the export prices of poor countries have been secularly declining, whereas the export prices of advanced countries have remained higher despite a rise in productivity. This has accentuated the global inequalities of income and wealth. For this crucial reason, the single factoral terms of trade cannot be an appropriate index of welfare and living standards.

(iv) Neglect of Increase in Productivity in Foreign Countries:

- The single factoral terms of trade give importance only to improvement in the productivity in the export sector. It fails to take into account the possible change in the productivity in the foreign countries and their resultant effect on the terms of trade. This deficiency was removed by **Jacob Viner through his introduction of the concept of double factoral terms of trade.**

2. Double Factoral TT: [DFTT]

- The DFTT is the NBTT adjusted for changes in the productivity in producing both imports as well as exports.

- **DFTT = NBTT * (Zx/Zm)**
- **Zm = Import Productivity**
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- A rise in the DFTT implies that one unit of home factors embodied in exports can now be exchanged for more units of the foreign factors embodied in imports

Limitations:

- This measure, being a derivative of a set of index numbers, suffers from all their drawbacks.
- This measure has no practical use.

Real Cost TOT

- It measures the gain from international trade in utility terms.
- It is calculated by multiplying the SFTT by the reciprocal of an index of the amount of disutility per unit of productive resources used in producing exports.
- RCTT = SFTT .Rx = NBTT .Zx. Rx
- where Rx= Index of the amount of disutility incurred per unit of productive factors in the export sector.

- A rise in the RCTT indicates that the amount of imports obtained per unit of real cost is greater.

Utility TOT

- >> It is an index of the relative utility of imports and domestic commodities foregone to produce exports.
- Given by the formula:
- UTT = RCTT . Um = NBTT .Zx. Rx. Um
- UTT = Utility TOT
- Um= Index of the relative utility of imports as compared with those productive factors which are at present devoted to the production of export goods

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