Topic 26: Terms of trade

Definition: The terms of trade index shows the value of a country's average export prices to their average import prices. Calculated by

$$Terms\ of\ trade = \frac{Weighted\ index\ of\ average\ export\ prices}{weighted\ index\ of\ average\ import\ prices} \times 100$$

Terms of trade index reflects the relative importance of different goods and services to the country's export revenue and import expenditure.

Base year is always taken at 100.

- When TOT increases, it is an improvement and that the country's exports will buy more imports.
- When TOT decreases, it is a deterioration and the country's exports can buy less imports.

Short run causes in a country's terms of trade

1. Changes in demand and supply for a country's exports and imports
2. Changes in relative inflation rate (inflation will reduce the competitiveness of a country's exports)
3. Changes in exchange rates

Long run causes in a country's terms of trade

1. Income changes: imports are induced expenditure
2. Long run improvements in productivity and technology: lower cost of production, lower prices, gradual deterioration of TOT

The significance of deteriorating terms of trade for developing countries

- There has been substantial increase in the supply of commodities due to technology
- Synthetic replacements for commodities has contributed to slow increase in demand for natural commodities
- Developed countries become richer and incomes have risen, demand for commodities has not greatly changed because demand is inelastic. Demand for commodities has increased less than demand for other goods
- Agricultural policies in developed countries damage world agricultural markets – price support schemes led to high prices and over production in developed economies, which are subsequently dumped on developing economies

The combination of low income elasticity of demand for commodities, increased use of synthetic substances and improvements in technology have led to relatively small increase in demand for commodities and a large increase in supply. Since TOT index is based on a weighted average of export prices, countries that are reliant on commodities will have a long term deterioration in their terms of trade.

This will lead to a depreciating current account deficit. The demand for imports is inelastic and the rise in import prices will lead to an increase in import expenditure.

Developing countries that rely on commodities will have to sell more and more exports to buy the same amount of imports. To increase export revenue they may reduce prices, however this will lead to a downward spiral.

Many developing countries have high levels of indebtedness and falling export revenue will make it harder to service their debt. In order to increase their export revenue they may overuse their resources resulting in negative externalities and is not suitable in the long run.