eLearneconomics: Trade – Terms of Trade (1)

Student response

(a) Define terms of trade.

Terms of trade ended June (1999 = 1 000)	
March years	Terms of trade
2002	1 081
2003	1 125
2004	1 118
2005	1 115
2006	1 098

(b) (i) Referring to the table, a favourable movement in the terms of trade occurred from:

(ii) What is the significance of 1999 = 1 000?

(c) Explain why an improvement in the terms of trade does not necessarily produce an improvement in the balance on the current account.

(d) Indicate if the following statements are correct or incorrect.

Statement	Correct or incorrect
(i) Export and import prices can change simultaneously and not necessarily in the same direction.	
(ii) If a country's terms of trade become unfavourable, a given quantity of exports will buy less imports than it used to.	
(iii) The terms of trade reflect the quantities of goods and services traded.	
(iv) A small country usually has little or no control over prices when selling and buying on international markets.	

eLearneconomics: Trade – Terms of Trade (1a)

Solutions

(a) Define terms of trade.

A ratio of export prices to import prices expressed as an index relative to a base year. The purchasing power of a given quantity of exports.

Terms of trade ended June (1999 = 1 000)	
March years	Terms of trade
2002	1 081
2003	1 125
2004	1 118
2005	1 115
2006	1 098

(b) (i) Referring to the table, a favourable movement in the terms of trade occurred from:

2002 to 2003

(ii) What is the significance of 1999 = 1 000?

This is the base year for the index from which percentage changes are calculated.

(c) Explain why an improvement in the terms of trade does not necessarily produce an improvement in the balance on the current account.

Recognising that the terms of trade is concerned with the price of exports and imports, while the balance on the current account is concerned with value and volumes, e.g. terms of trade may be improving, but, if export receipts are less than import payments the balance on the current account may deteriorate.

(d) Indicate if the following statements are correct or incorrect.

Statement	Correct or incorrect
(i) Export and import prices can change simultaneously and not necessarily in the same direction.	correct
(ii) If a country's terms of trade become unfavourable, a given quantity of exports will buy less imports than it used to.	correct
(iii) The terms of trade reflect the quantities of goods and services traded.	incorrect
(iv) A small country usually has little or no control over prices when selling and buying on international markets.	correct

eLearneconomics: Trade – Terms of Trade (2)

Student response

(a) Read the extract and answer the questions that follow.

Assume that New Zealand's terms of trade have improved.

(i) Explain what is meant by the idea that 'New Zealand's terms of trade have improved'.

(ii) Explain one positive impact and one negative impact of an improvement in New Zealand's terms of trade.

(iii) Draw a conclusion as to whether or not an improvement in New Zealand's terms of trade is beneficial for the economy.

Solutions

(a) Read the extract and answer the questions that follow.

Assume that New Zealand's terms of trade have improved.

(i) Explain what is meant by the idea that 'New Zealand's terms of trade have improved'.

An improvement in the terms of trade means that the purchasing power of our exports has improved, i.e., it takes fewer exports to pay for the given unit of imports.

(ii) Explain one positive impact and one negative impact of an improvement in New Zealand's terms of trade.

Positive impact: The Balance on Goods is likely to improve (assuming stable volumes of exports and imports) as export receipts increase at a greater rate than import payments. Businesses are likely to expand and employ more workers. Government tax revenue will rise from company taxes, increased direct tax receipts because of higher employment levels.

Negative impact: Economic growth is likely to increase resulting in inflationary pressures in the economy. Interest rates may rise with inflationary pressures. This will increase the cost of borrowing, credit cards.

(iii) Draw a conclusion as to whether or not an improvement in New Zealand's terms of trade is beneficial for the economy.

New Zealand is likely to be better off with business expansion, economic growth and job opportunities, there may be some pressures on prices (inflation).