TERMS OF TRADE

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The terms of trade is an index which measures the relative movements in export and import prices. It is measured using the following equation:

\[ \text{Terms of Trade} = \frac{\text{Export price index}}{\text{Import price index}} \times 100 \]
Terms of Trade

When export prices are rising relative to import prices, this is said to be a favourable movement. This is because more imports can be purchased from the same volume of exports. The additional imports represent an increase in welfare.

When export prices fall relative to import prices, it is said to be an unfavourable movement since less imports can be purchased from the same volume of exports. The reduced imports represent a fall in welfare.
The following situations would lead to a favourable movement in the terms of trade:

- Export prices rising faster than import prices
- Export prices rising while import prices remain constant
- Export prices rising while import prices fall
- Export prices constant while import prices fall
- Export prices fall slower than import prices falling

Changes in the Terms of Trade
The following situations would be unfavourable movements in the terms of trade:

- Import prices rising faster than export prices falling
- Import prices rising while export prices stay constant
- Import prices rising while export prices fall
- Import prices constant while export prices fall
- Import prices falling slower than export prices falling
A change in the terms of trade will have an impact on the balance of merchandise trade in the balance of payments. This is dependent upon the price elasticity of demand for exports and imports. If the demand for exports and imports is elastic, a deterioration of the terms of trade will improve the merchandise trade balance. If the demand is inelastic, a deterioration will worse the merchandise trade balance. An improvement in the terms of trade will have the opposite effect.
Less imports can be purchased with a given volume of exports OR More exports are required to purchase a given volume of exports - Purchasing power of the nation declines.
Terms of Trade Summary

- Favourable movement

More imports can be purchased with a given volume of export OR
Less exports are required to purchase a given volume of

- Purchasing power of the nation

Diagram:

Price vs. Time

- Line X indicates an increase in price over time.
- Line M indicates a decrease in price over time.