CIE Economics AS-level

Topic 4: The Macroeconomy

e) The terms of trade

Notes

The measurement of the terms of trade

The terms of trade measures the volume of imports an economy can receive per unit of exports. It is calculated by the index price of exports over the index price of imports.

Terms of trade above 100 are improving, whilst those below 100 are worsening.

An example calculation is:

- The index price of exports increases by 15%. The index price of imports increases by 20%. The terms of trade are (115/120) x 100 = 95.83. This means that the terms of trade has reduced, so the economy gets fewer imports per unit of exports.

Causes of changes in the terms of trade

Globalisation has meant that the price of invisibles, such as services, has been less impacted than visibles, such as manufactured goods. The price of manufactured goods has fallen more than services. This means that the terms of trade of countries, such as the UK which export more services and import more manufactured goods, has improved.

The **Prebisch-Singer hypothesis** suggests that over time, due to falling commodity prices in relation to manufactured goods, the terms of trade for developing countries has fallen. Due to globalisation reducing the price of manufactured goods, this effect has been offset slightly.

The impact of changes in the terms of trade

Improving terms of trade mean the economy can import more goods for each unit of export. This can help reduce the effects of cost-push inflation, since import prices are falling relative to export prices. However, it can mean that the balance of payments worsens, since there are fewer exports and more imports.

Worsening terms of trade means that for every import, the country has to export more.