

Edexcel (A) Economics A-level  
**Theme 4: A Global Perspective**

4.1 International Economics

4.1.4 Terms of trade

Notes



### **Calculation of 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  $(115/120) \times 100 = 95.83$ . This means that the terms of trade has reduced, so the economy gets fewer imports per unit of exports.

### **Factors influencing a country's 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 price elasticity of demand impacts the terms of trade. The more inelastic the demand for exports than imports, the more favourable the terms of trade, since the country can demand higher prices for exports.

If a country only imports manufactured goods and only exports primary goods, then the terms of trade will be worse.

An appreciation in the country's exchange rate results in an improvement in the terms of trade, since this results in an increase in export prices and a decrease in the price of imports.

If a country employs a protectionist measure, then the terms of trade will improve because imports are restricted. This is providing other countries do not retaliate.

A country with a higher population demands more imports, so they are likely to have a relatively worse terms of trade compared to a country with a smaller population.



## The impact of changes in a country's 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. It could also help improve standards of living for consumers in the country.

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. It could make the price of new technology more expensive, which might limit productivity.

It could lead to a fall in living standards, and because it is more difficult to earn foreign currency, it becomes harder to pay foreign debt.

