2. TERMS OF TRADE

Q:1 Explain the Concept of terms of trade?

Ⓐ **Introduction** :- International trade is based on International Specialisation. Terms of Trade means the rate at which one Country's Products are exchanged with other country's Product.

IF Export Price is greater than Import Price, The Terms of Trade will be Favourable to Country.

IF Import Price is greater than Export Price, the terms of Trade will be Unfavourable to Country.

Ⓑ **Terms OF Trade** :- "Terms of trade means the Ratio OF Price of its export commodity to the Price of its Import Commodity".

Symbolically $T = \frac{P_x}{P_M} \times 100$

Ⓒ **Example** If Price of Export $= P_x =$ ₹90 and Price of Import $= P_m =$ ₹95

$$\therefore T = \frac{P_x}{P_M} \times 100$$

$$T = \frac{90}{95} \times 100$$

$$T = 94.73$$

Terms OF Trade above 100 is Favourable to Exporting Country. and Less than 100 is Unfavourable.

(D) Types of Terms of Trade :-

(I) Terms of Trade Relating to Ratio of Exchange between Commodities

1. Net barter Terms of Trade
2. Gross barter Terms of Trade
3. Income Terms of Trade

(II) Terms of Trade relating to Ratio of Exchange between Productive Resources

1. Single Factoral T.O.T
2. Double Factoral TOT.

Q8.2 Explain the different methods of Measuring Terms of Trade?

(I) Terms of Trade Relating to Ratio of Exchange between Commodities :-

1. Net Barter Terms of Trade (NBTT) :-

This is most popular and commonly used method to measure the changes in terms of trade.

" The Ratio of Price of Exports to the Price of Imports is Known as Net Barter Terms of Trade "

$$\boxed{NBTT = \frac{P_x}{P_m} \times 100}$$

If $P_x > P_m$, terms of trade are favourable and

If $P_x < P_m$, terms of trade are Unfavourable.

Example - IF in Current year, Export Price index = 125
Import Price index = 150

$$\text{Terms of Trade} = \frac{P_X}{P_M} \times 100$$

$$T = \frac{125}{150} \times 100$$

$$T = 83.33$$

The concept of NBTT is very useful device For measuring short-term changes in Trading Position

★ Limitations OF NBTT :-

i) The Commodity terms of trade only deals with Prices but it do not Consider changes in Quality of Exports and Imports.

ii) It ignore changes in Productivity of export sector and Unilateral transactions.

iii) NBTT are based on Index number, but there are Various Problems in Construction OF Index Number.

iv) NBTT takes into Consider Tangible goods only. It does not consider non-mercantile items.

v) It neglects changes in Composition OF Trade and Quality of Goods traded.

2 Gross Barter Terms OF Trade (GBTT) :-

Due to Various Limitations of NBTT method, Taussig developed New method of measuring terms of trade called Gross Barter Terms OF Trade (GBTT).

According to Taussig instead of relating import and export Prices we should relate quantities of imports and exports.

$$\boxed{GBTT = \frac{Q_m}{Q_x} \times 100}$$

Example Quantity of Import = 150
Quantity of Export = 125

$$GBTT = \frac{Q_M}{Q_X} \times 100$$
$$= \frac{150}{125} \times 100$$
$$GBTT = 120$$

Here GBTT is favourable, IF GBTT is below 100, it shows unfavourable Terms of trade.

★ Limitation OF GBTT :-

1. This method do not consider Prices of Import and Export.
2. This method ignores capital movement From One Country to another country.
3. It wrongly include Unilateral Payments
4. It express the terms of Trade in terms of quantity instead of Prices.

3 Income Terms OF Trade :-

This is Very Useful method of measuring terms of trade. This Income Terms of trade is developed by G.S. Dorranc. He consider Quantity of export with Prices of imports and Exports.

$$\text{Income Terms of Trade} = \frac{P_x}{P_m} \times Q_x$$

Income Terms of Trade is Superior concept. Other thing being equal, The capacity to import increase when Export Price increase or Import Price decreases.

★ Limitations :-

1. It do not consider foreign Exchange receipts.
2. It do not consider Welfare aspect of Trade.
3. It does not measure Precisely (clearly) the gain or Loss.

II Terms of Trade Relating to Exchange between Productive Resources of Two Countries :-

1. Single Factoral Terms of Trade :-

To reduce the Limitations of commodity terms to trade, Prof. Viner developed Single factoral Terms of trade.

Prof. Viner consider Productivity index of export sector with Prices of Export and Import.

$$\text{Single Factoral Terms of Trade} = T_s = \frac{P_x}{P_m} \times Z_x$$

Z_x = Productivity Index of Export sector.

Example - $P_X = 95$, $P_M = 110$
$Z_x = 125$ then Single Factoral Term of Trade =

$$T_S = \frac{P_X}{P_M} \times Z_X$$

$$T_S = \frac{95}{110} \times 125$$

$$T_S = \underline{107.95}$$

Thus the exporting country received **7.95%** more import per unit of domestic factors.

★ Limitations

1) Some time Comparisions between Two Periods Prices and Productivity is not Possible.
2) It is difficult to Collect data For Constructing Index number.
3) This method Consider Production cost of export only. But it does not consider Production Cost of Import goods.

2. Double Factoral Terms of Trade :-

To reduce the drawbacks of Single Factoral Terms of trade, Prof. Viner constructed another Index method called - Double Factoral Terms of Trade. Here Prof. Viner, considered Productivity Index of Export goods and Productivity Index of Import goods.

Double Factoral Terms of trade shows Factors Used in Exports Exchanged For the Foreign Factors Used in Imports.

Double Factoral Terms of Trade = T_D

$$T_D = \frac{P_x}{P_m} \times \frac{Z_x}{Z_m} \times 100$$

Z_x = Export Productivity Index

Z_m = Import Productivity Index.

Example:- $P_x = 95$ $P_M = 110$, $Z_x = 130$ $Z_m = 105$

$$T_D = \frac{P_x}{P_m} \times \frac{Z_x}{Z_m} \times 100$$

$$T_D = \frac{95}{110} \times \frac{130}{105} \times 100$$

$$T_D = 106.92$$

From above example we can say that the Double Factoral terms of trade are favourable for exporting country.

★ Limitations :-

1) It is difficult to construct Productivity index for
2) Changes in Productivity is Less important trading countries.
3) It is not possible to compare Productivity Index in Export and Import Countries due to different Political and Socio-economic conditions.

Q:3 Explain the factors affecting terms of trade?

A] Introduction
B] Terms of Trade] Same from Q:1

C] **Factors affecting Terms of Trade :-**

Terms of Trade may be favourable or Unfavourable for a Country depending upon many factors. They are—

1. **Change in Taste and Preference :-** Demand for many goods depends upon Taste, Preference, fashion habits of consumers. Change in demand have direct affect on Terms of Trade.

2. **Nature of Commodities :-** Different countries deal with different types of goods.
Example - Developing and Poor Countries exports mainly Necessary goods which command low Price. But Developed countries export capital and manufactured good which command High Price.

3. **Depreciation of Currency :-** If a country's Currency depreciates then exports will become Cheaper and Imports will become costlier. It will lead to change in terms of trade.

4. **Improvement in Technology :-** Advanced and New Technology helps to reduce cost which improve Terms of Trade.

5. Reciprocal Demand :- The intensity of demand for other country's goods also Change Terms of Trade.

Example :- IF China's demand for India's goods is strong and increasing as compare to India's demand for Chinese goods, then Terms of Trade are adverse to China.

6. Changes in Factor Endowments :- Availability of Factors of Production like - Capital and labour also affect terms of trade.

Increase in factor endowments (availability) will increase Export of country and vice versa.

7. Economic Development :- During development Process an economy changes in technology, Quality of inputs, work-Culture, Infrastructural facilities which may affect on terms of trade.