

# Terms of Trade

- The terms of trade refer to the rate at which one country exchanges its goods for the goods of other countries. Thus, terms of trade determine the international values of commodities.
- The terms of trade depend upon the prices of exports a country and the prices of its imports.
- Terms of trade (TOT) represent the ratio between a country's export prices and import prices.

# Types of Terms of Trade

## **Net Barter Terms of Trade:**

The commodity or Net barter system is the ratio of the prices a country gets for its exports to the prices it pays for its imports. This price ratio when compared to some base year ratio, the terms of trade can be understood as improved or deteriorated. For this, an index number of a country's exports and imports prices of the base and current years are used.

The new terms of trade can be achieved by comparing new export prices as shown below.

$$T_C = P_{x1}/P_{x0} \div P_{m1}/P_{m0} \times 100$$

Or

$$P_{x1}/P_{m1} \times 100$$

Where,

$T_C$  stands for net barter terms of trade.

$P_x$  stands for price of exports (x),

$P_m$  stands for price of imports (m)

Suppose, base year is 2010 and the price index for imports and exports for that year is 100. If the 2015 price index of export and import changes to 125 and 150 respectively, the terms of trade will be –

$$125/150 * 100 = 83.66$$

Thus, due to increase in imports, terms of trade worsened.

- Drawbacks:

1. Quality neglected
2. Difficulty in construction of index number due to volatility in trade
3. Services are ignored
4. Prices, rather than income are considered.
5. Neglects productivity of imports

## 2. Gross Barter Terms of Trade:

$$T_M = Q_{M1}/Q_{M0} \div Q_{X1}/Q_{X0} \times 100$$

Or

$$Q_{M1}/Q_{X1} \times 100$$

A favourable gross barter terms of trade indicates that the country in question can have more imports for a given exports. In other words, its capacity to import increases.

- Gross Barter ToT includes all items under Balance of Payments.
- Criticism:
- Considers quantity instead of price
- It explains changes in BoP instead of explaining changes in import-exports.

# Income Terms of Trade

$$T_Y = P_X/P_M * Q_X$$

Or

$$T_Y = T_C * Q_X$$

An improvement in income ToT indicates that there is an increase capacity to import, hence some economists consider it as a better explanation of gains of trade.

# Factors Affecting ToT

1. Change in factor endowment
2. No change in reciprocal demand
3. Improvement in technology
4. Changes in Taste
5. Tariffs
6. Economic Development
7. Depreciation of Currency

# Gains from Trade

- Gains from trade depend upon terms of trade.
- A better price of exports or decline in imports leads to improvement in terms of trade. On the other hand, an increase in import prices and a stationary or declining export prices will worsen the ToT, and accordingly gains from trade too.
- The gains from trade are maximum if the international terms of trade prevailing are nearer to the other country's internal terms of trade.

# Free Trade Vs Protectionism

- International trade that takes place without barriers such as tariff, quotas and foreign exchange controls is called free trade, whereas protectionism refers to restricted trade.
- Classical economists Adam Smith and David Ricardo—argued that free flow of goods and services, i.e., unrestricted trade, would be beneficial.
- After the World War II (1939-1945), commercial policy underwent a change when the wave of protectionism swept all over the world.

# Arguments for Free Trade

- **(i) Advantages of specialisation:**

- Firstly, free trade secures all the advantages of international division of labour. Each country will specialise in the production of those goods in which it has a comparative advantage over its trading partners. This will lead to the optimum and efficient utilisation of resources and, hence, economy in production.

- **(ii) All-round prosperity:**

Secondly, because of unrestricted trade, global output increases since specialisation, efficiency, etc. make production large scale. Free trade enables countries to obtain goods at a cheaper price. This leads to a rise in the standard of living of people of the world. Thus, free trade leads to higher production, higher consumption and higher all-round international prosperity.

- **(iii) Competitive spirit prevails:**
- Thirdly, free trade keeps the spirit of competition of the economy. As there exists the possibility of intense foreign competition under free trade, domestic producers do not want to lose their grounds. Competition enhances efficiency. Moreover, it tends to prevent domestic monopolies and free the consumers from exploitation.
- **(iv) Accessibility of domestically unavailable goods and raw materials:**
- Fourthly, free trade enables each country to get commodities which it cannot produce at all or can only produce inefficiently. Commodities and raw materials unavailable domestically can be procured through free movement even at a low price.

**(v) Greater international cooperation:**

Fifthly, free trade safeguards against discrimination. Under free trade, there is no scope for cornering raw materials or commodities by any country. Free trade can, thus, promote international peace and stability through economic and political cooperation.

**(vi) Free from interference:**

Finally, free trade is free from bureaucratic interferences. Bureaucracy and corruption are very much associated with unrestricted trade.

# Arguments against Free Trade

## **(i) Advantageous not for LDCs:**

- Firstly, free trade may be advantageous to advanced countries and not to backward economies. Free trade has brought enough misery to the poor, less developed countries, if past experience is any guide. India was a classic example of colonial dependence of UK's imperialistic power prior to 1947. Free trade principles have brought colonial imperialism in its wake.

## **(ii) Destruction of home industries/products:**

- Secondly, it may ruin domestic industries. Because of free trade, imported goods become available at a cheaper price. Thus, an unfair and cut-throat competition develops between domestic and foreign industries. In the process, domestic industries are wiped out. Indian handicrafts industries suffered tremendously during the British regime.

### **(iii) Inefficient industries remain perpetually inefficient:**

- Thirdly, free trade cannot bring all-round development of industries. Comparative cost principle states that a country specialises in the production of a few commodities. On the other hand, inefficient industries remain neglected. Thus, under free trade, an all-round development is ruled out.

### **(iv) Danger of overdependence:**

- Fourthly, free trade brings in the danger of dependence. A country may face economic depression if its international trading partner suffers from it. The Great Depression that sparked off in 1929-30 in the US economy swept all over the world and all countries suffered badly even if their economies were not caught in the grip of depression. Such overdependence following free trade becomes also catastrophic during war.

### **(v) Penetration of harmful foreign commodities:**

- Finally, a country may have to change its consumption habits. Because of free trade, even harmful commodities (like drugs, etc.) enter the domestic market. To prevent such, restrictions on trade are required to be imposed.
- In view of all these arguments against free trade, governments of less developed countries in the post-Second World War period were encouraged to resort to some kind of trade restrictions to safeguard national interest.

# Protectionism

- By protection we mean restricted trade. Foreign trade of a country may be free or restricted. Free trade eliminates tariff while protective trade imposes tariff or duty. When tariffs, duties and quotas are imposed to restrict the inflow of imports then we have protected trade. This means that government intervenes in trading activities.
- Forms of Protection:
  1. Tariff
  2. Import Quota
  3. Voluntary Export Restraints
  4. License
  5. Health and Safety Regulations

# Arguments for Protectionism

## **(a) Infant industry argument:**

- When an industry is first established its costs will be higher. It is too immature to reap economies of scale at its infancy. Workers are not only inexperienced but also less efficient. If this infant industry is allowed to grow independently, surely it will be unable to compete effectively with the already established industries of other countries.
- Thus, an infant industry needs protection of a temporary nature and over time will experience some sort of 'learning effect'. Given time to develop an industry, it is quite likely that in the near future it will be able to develop a comparative advantage, withstand foreign competition and survive without protection.

## **(b) Diversification argument:**

- As free trade increases specialisation, so protected trade brings in diversified industrial structure. By setting up newer and variety of industries through protective means, a country minimises the risk in production. Comparative advantage principle dictates narrow specialisation in production.

## **(c) Employment argument:**

- Protection can raise the level of employment. Tariffs may reduce import and, in the process, import-competing industries flourish. In addition, import- substituting industries—the substitution of domestic production for imports of manufactures—develop. The strategy of import-substituting industrialisation promotes domestic industry at the expense of foreign industries.

### **(d) Balance of payments argument:**

- A deficit in the balance of payments can be cured by curtailing imports. However, imports will decline following a rise in tariff rate provided other trading partners do not retaliate by imposing tariff on a country's export. However, import restrictions through tariff may be uncalled for if the balance of payments crisis becomes serious and chronic. In view of this and other associated problems of tariff, it is said that tariff is a second best policy.

### **• (e) Anti-dumping argument:**

- Dumping is a form of price discrimination that occurs in trade. Dumping occurs when a country sells a product abroad at a low price because of competition and at a high price in the home market because of monopoly power.
- In other words, dumping is a kind of subsidy given to export goods. This unfair practice can be prevented by imposing tariff. Otherwise, workers and firms competing with the dumped products will be hit hard.

## **(f) Strategic trade advantage argument:**

- It is argued that tariffs and other import restrictions create a strategic advantage in producing some new products having potential for generating some net profit. There are some large firms who prevent entry of new firms because of the economies of large scale production. Thus, these large firms reap pure profits over the long run during which new firms may not dare enough to compete with these established large firms. Thus, the large scale economies themselves prevent entry of new firms.
- If protection in the domestic market can increase the chance that one of the protected domestic firms will become one of the established firms in the international market, the protection may pay off.

### **(g) National defence argument:**

- There are some industries which may be inefficient by birth or high cost due to many reasons and must be protected. This logic may apply to the production of national defence goods or necessary food items. Whatever the cost may be, there is no question of compromise for the defence industry since 'defence is more important than opulence'. Dependence on foreign countries regarding supply of basic food items as well as defence products is absolutely unwise.

- **Miscellaneous arguments against protection:**

- Firstly, protection distorts the comparative advantage in production. This means that specialisation in production may be lost if a country imposes tariff. All these lead to squeezing of trade.
- Secondly, it imposes a cost on the society since consumers buy goods at a high price.
- Thirdly, often weak declining industries having no potential future stay on the economy under the protective umbrella.
- Fourthly, international tension often escalates, particularly when tariff war begins. Usually, a foreign country retaliates by imposing tariff on its imports from the tariff-imposing country. Once the retaliatory attitude (i.e., 'beggar-my-neighbour policy') develops, benefits from protection will be lost.
- Finally, protection encourages bureaucracy. Increase in trade restrictions means expansion of governmental activity and, hence, rise in administrative cost. Bureaucracy ultimately leads to corruption.

# Recent Trends in International Trade

- International trade can be broadly distinguished between trade in goods (merchandise) and services.
- The bulk of international trade concerns physical goods, while services account for a much lower share.
- World trade in goods has increased dramatically over the last decade, rising from about US\$10 trillion in 2005 to more than US\$18.5 trillion in 2014 to then fall in 2016 and reach US\$18.8 trillion in 2019. Trade in services greatly increased between 2005 and 2019 (from about US\$2.5 trillion to close to US\$6 trillion).
- The value of international trade of both goods and services declined substantially in 2015 and 2016, later recovered during 2017 and 2018, only to level off (services) or fall (goods) during 2019 (Figure 1a). Following the strong rebound in 2010 and 2011, export growth rates (in current dollars) turned negative both in 2015 and 2016 (Figure 1b).
- They showed a strong bounce back to a positive territory in 2017 – especially for goods' exports from developing countries – but remained below pre-crisis levels. During 2019 export growth rates for both goods and services greatly declined, with rates for goods from developed countries turning negative.

- COVID-19 has had an immediate and strong impact on international trade.
- The first signs of the trade downturn were already evident in January 2020, with most of the major economies recording negative trends. Still, the sharpest drop in international trade occurred in the second quarter of 2020, with global merchandise trade falling by more than 20 per cent relative to the same quarter of 2019.
- The sharp decline in international trade during 2020 has been widespread but more pronounced in developed countries, especially in relation to exports.
- Trade among developing countries has been slightly more resilient than overall trade.

- The relatively lower drop of developing countries' trade is largely due to the trade resilience of East Asian countries.
- While no developing country region has been spared from the decline in international trade during 2020, trade trends for the East Asian region are generally better.
- This trend is even more evident for Q3 2020, as East Asian exports turned positive on a year-over-year basis. While improving relative to Q2, trade trends in Q3 remain negative for the other developing-country regions. As an example, the value of trade originating from transition economies and the West Asia and North Africa region was about 25 per cent lower in Q3 2020 than in Q3 2019.

- International trade declined for all but a handful of countries, however the magnitude of the drops has varied. For example, many East Asian countries have been performing relatively better. More markedly, trade patterns for 2020 have been very heterogeneous within Africa.
- While the value of international trade dropped for most of Southern Africa, trade has increased for a few countries, especially in the West African region. Differences are also present in the East Asian and Pacific regions and not all countries in Latin American have seen double digit drops in their trade during the first nine months of 2020.

- China's trade patterns have been notably different relative to other economies. China's economy was the first to be affected by COVID-19 and after falling in the early months of the pandemic, Chinese exports were already stabilizing in Q2 2020 and then rebounding strongly during Q3 2020, with yearover-year growth rates of almost 10 per cent. Overall, the level of Chinese exports for the first nine months of 2020 was comparable to that of 2019 over the same period. On the import side, the Chinese demand for imported products also recovered, but less than exports.

- The recovery process has lagged in many of the other major economies, some of which still recorded double digit drops in September 2020. For example, imports and exports have remained substantially below 2019 levels for Brazil, India, Japan, and the Russian Federation. On the other hand, signs of a tepid recovery are found in the statistics of the European Union, Republic of Korea, and South Africa.

## Import and Exports trends of major economies

Imports	January	February	March	April	May	June	July	August	September
Brazil	-1	5	11	-15	-11	-20	-35	-29	-25
China	-7	-10	-1	-14	-17	3	-1	-2	13
European Union	-3	-7	-12	-26	-28	-12	-15	-10	-2
India	0	4	-28	-60	-51	-48	-30	-26	-20
Japan	-5	-13	-1	-3	-25	-14	-21	-21	-14
Republic of Korea	-5	1	0	-16	-21	-11	-12	-16	1
Russian Federation	4	2	-2	-20	-13	-4	-13	-11	-3
South Africa	-3	-4	-17	-38	-40	-43	-39	-31	-15
United States	-4	-4	-7	-21	-25	-13	-8	-5	0

Exports	January	February	March	April	May	June	July	August	September
Brazil	-19	-1	5	-9	-15	-5	-3	-11	-10
China	-22	-10	-7	3	-3	1	7	9	10
European Union	-2	-3	-8	-31	-32	-9	-10	-9	3
India	-1	4	-34	-61	-35	-12	-10	-13	4
Japan	-4	0	-8	-19	-27	-25	-18	-15	-3
Republic of Korea	-7	4	-2	-26	-24	-11	-7	-10	7
Russian Federation	-2	-18	-20	-33	-36	-26	-28	-32	-14
South Africa	10	6	-1	-61	-28	-6	-14	-3	10
United States	0	2	-9	-29	-36	-24	-15	-15	-9

- Sectoral Trends in International Trade:
- Economic disruptions brought about by COVID-19 have affected international trade in some sectors significantly more than others.
- For example, the value of global trade in the energy sectors has been the one declining the most, with a drop of more than 35 per cent in value.
- Steeper declines were also observed in the automotive sectors (motor vehicles and transport equipment).
- Trade also declined significantly in machineries and the sector comprising metals and ores.
- Conversely, most of the agri-food sectors (with the exception of tobacco and beverages) have been stable or recorded a small increment.
- Trade significantly increased in the textile sectors (10 per cent relative to the same period of 2019). Such increases are linked to the COVID-19 pandemic as these sectors include protective equipment such as surgical masks.
- To a lesser degree, COVID-19 also affected the trade of office machinery which benefited from increased demand for home office equipment.