Income Terms of Trade:

In order to improve upon the net barter terms of trade G.S. Dorrance developed the concept of income terms of trade which is obtained by weighting net barter terms of trade by the volume of exports. Income terms of trade therefore refer to the index of the value of exports divided by the price of imports. Symbolically, income terms of trade can be written as

Ty = Px.Qx/Pm

Where

T_y = Income terms of trade

P_x = Price of exports

Q_x = Volume of exports

P_m= Price of imports

Income terms of trade yields a better index of the capacity to import of a country and is, indeed, sometimes called 'capacity to import. This is because in the long run balance of payments must be in equilibrium the value of exports would be equal to the value of imports.

thus, in the long run:

Pm, Qm = Px, Qx

Qm = Px.Qx/Pm

It follows from above that the volume of imports (Qm) which a country can buy (that is, capacity to import) depends upon the income terms of trade i.e., Px.Qx/Pm. Since income terms of trade is a better indicator of the capacity to import and since the developing countries are unable to change Px and Pm. Kindleberger' thinks it to be superior to the net barter terms of trade for these countries, However, it may be mentioned once again that it is the concept of net barter terms of trade that is usually employed.

Determination of Terms of Trade: Theory of Reciprocal Demand:

As seen above, the share of a country from the gain in international trade depends on the terms of trade. The terms of trade at which the foreign trade would take place is determined by reciprocal demand of each country for the product of the other countries.

The theory of reciprocal demand was put forward by JS. Mill and is thought to be still valid and true even today. By reciprocal demand we mean the relative strength and elasticity of the demand of the two trading countries for each other's product.

Let us take two countries and B which on the basis of their comparative costs specialise in the production of cloth and wheat respectively. Obviously, country would export cloth to country B, and in exchange import wheat from it. Reciprocal demand means the strength and elasticity of demand of country A for wheat of country B, and the intensity and elasticity of country B's demand for cloth from country A If the country has inelastic demand for wheat of country B, she will be prepared to give more of cloth for a given amount of wheat. In this case terms of trade will be unfavourable to it and consequently its share of gain from trade will be relatively smaller.

On the contrary, if country A's demand for import of wheat is elastic, it will be willing to offer a smaller quantity of its cloth for a given quantity of the imports of wheat. In this case terms of trade would be favourable to country A and its share of gain from trade will be relatively larger. The equilibrium terms of trade would settle at a level at which its reciprocal demand, that is, quantity of its exports which it will be willing to give for a given quantity of its imports is equal to the reciprocal demand of the other country.

Note that the equilibrium terms of trade are determined by the intensity of reciprocal demand of the two trading countries but they will lie in between the comparative costs (i.e., domestic exchange ratios) of the two countries. This is because no country would be willing to trade at a price which is lower than at which it can produce at home.

Factors Affecting the Terms of Trade:

1. Reciprocal Demand:

The reciprocal demand signifies the intensity of demand for the product of one country by the other. If the demand for cloth, exportable commodity of country A, is more intense (or inelastic) in country B, the latter will offer more units of steel, its exportable product, to import a given quantity of cloth. On the contrary, if the demand for cloth in country B is less intense (elastic), then B will offer smaller quantity of steel to import the given quantity of cloth.

If the reciprocal demand for steel in country A increases, the offer curve of country A will shift to the right as it will be willing to offer more quantity of cloth for the given import of steel. On the contrary, a decrease in the reciprocal demand for steel in country A, will cause a shift in its offer curve to the left as it will offer a lesser quantity of cloth to import the same quantity of steel. In the former case, the terms of trade get worsened and in the latter case they get improved for country A.

From the point of view of country B, if there is an increase in the reciprocal demand for cloth in country B, the offer curve of this country will shift to the left and the terms of trade for this country become favourable. On the opposite, a decrease in the reciprocal demand for cloth in country B results in a shift in the offer curve of this country to the right. The consequence is the worsening of the terms of trade for this country.

2. Changes in Tastes:

The terms of trade of a country may also be affected by the changes in tastes. If tastes or preferences of the people in country A shift from the product Y of country B to its own product X, the terms of trade will become favourable to country A. In an opposite situation, the terms of trade will turn against this country.

3. Tariff:

When a country imposes tariffs on imports from the foreign country, it implies a lesser willingness to absorb the foreign products. It means the reciprocal demand in the tariff-imposing country for the foreign product has got reduced. The tariffs or import duties are, therefore, likely to improve the terms of trade for the tariff- imposing country.

4. Changes in Technology:

The terms of trade of a country get affected also by the changes in techniques of production. As there is technological improvement in the home country, say A, there is rise in productivity and/or a fall in the cost of producing exportable commodity, say cloth. If the technological progress is labour-saving in this labour-intensive export sector (cloth industry) there will be worsening of the terms of trade as the offer curve of country A will shift to the right.

5. Economic Growth:

The economic growth involves a rise in real national product or income of a country over a long period. As growth takes place, there is an expansion in the productive capacity of the country. The increased productive capacity may result from the increased supply of productive factors. It is supposed that there are two countries A and B. The former is the labour-abundant home country and cloth is its exportable product, which is labour-intensive. Steel, the capital-intensive commodity, is its importable product from the foreign country B.

As the supply of labour in the labour- abundant country A increases or growth takes place, the offer curve of this country will shift to the right. The cost and price of exportable commodity falls relative to the cost and price of steel in country B. As a result, this country will offer more quantity of cloth for the same quantity of steel. In this situation, the terms of trade will get worsened for the growing home country A, although the volume of trade will get enlarged.

If the supply of scarce factor capital increases, subsequent to growth, the cost and price of importable good steel will fall relative to the price of cloth. More quantity of steel can be obtained for the same quantity of cloth. In this case, the offer curve of country A will shift to the left. This will cause the improvement in the terms of trade for the growing home country A but the volume of trade will get reduced.

6. Devaluation:

Devaluation is the reduction of the value of home currency in relation to the value of foreign currency. Since devaluation causes a lowering of export prices relative to import prices, the terms of trade are supposed to get worsened after devaluation of the home currency. In fact there is much controversy about the impact of devaluation upon the terms of trade among the economists. F.D. Graham and several other classical theorists held the view that the devaluation would leave the terms of trade unaffected because the countries transact at the international prices upon which they have little control.

The neo-classical, theorists, including Joan Robinson, on the contrary, maintained that most countries specialised in the export of a few commodities, the foreign demand of which was relatively inelastic while, at the same time, they imported such goods, the supply of which was relatively more elastic. Consequently devaluation tends to deteriorate their terms of trade.

7. Balance of Payments Position:

If a country is faced with a deficit in balance of trade and payments and it has to adopt measures intended to restrict import and enlarge exports such as internal deflation, devaluation, import and exchange controls, the terms of trade are likely to get worsened. On the opposite, a trade and payments surplus may be tackled through the exchange appreciation and reflationary policies. As a consequence, the terms of trade may get improved.

8. International Capital Flows:

An increased flow of capital from abroad involves larger demand for the products of the creditor country and consequent rise in the prices of imported goods. The rise in prices of imports relatively to the prices of exports causes deterioration in the net barter terms of trade. When the borrowing country makes repayments of outstanding loans, there is outflow of capital.

In order to get hold of required foreign currencies for making repayments, there may be sale of home-produced goods at rather low prices. The fall in export prices relative to import prices will again result in the deterioration in the net barter terms of trade.

9. Import Substitutes:

If there is sufficient production of close substitutes for import goods within the home country, its reciprocal demand for the foreign products will be weak and the terms of trade are likely to become favourable for the home country. On the opposite, if the close substitutes of the import goods are not available in the home country, the reciprocal demand for foreign products may be relatively high. As a result, the terms of trade are likely to be unfavourable for the home country.

There can be several other minor influences upon the terms of trade such as price movements, business cycles, transfer problems and political conditions.

What Is Trade Protectionism?

Trade protectionism is a measured and purposeful move by a country to control imports while promoting exports. It is done in an effort to promote the economy of the country above all other economies.

For example, if a U.S. auto company were to move all of its operations out of foreign countries to the U.S., cars made in the U.S. would become more expensive. If tariffs were put on foreign cars, this move would make it so the cars made in the U.S. weren't any more expensive than those being exported from other countries.

Advantages Explained

- **Protects a country's new industries from foreign competition**: If a country is trying to grow strong in a new industry, tariffs will protect it from foreign competitors. That gives the new industry's companies time to develop their competitive advantages.
- **Temporarily creates jobs for domestic worker**s: The protection of tariffs, quotas, or subsidies allows domestic companies to hire locally. This benefit ends once other countries retaliate by erecting protectionism.[7]

Disadvantages Explained

- **Companies without competition decline in quality**: In the long term, trade protectionism weakens industry. Without competition, companies do not need to innovate. Eventually, the domestic product will decline in quality and be more expensive than what foreign competitors produce.
- **Leads to outsourcing of jobs**: Job outsourcing is a result of declining U.S. competitiveness. Competition has declined from decades of the U.S. not investing in education. This failure is particularly true for high-tech, engineering, and science. Increased trade opens new markets for businesses to sell their products. The Peterson Institute for International Economics estimates that ending all trade barriers would increase U.S. income by $500 billion.[8]
- **Slows economic growth**: Protectionism causes more layoffs, not fewer. If the U.S. closes its borders to trade, other countries will do the same. These actions could cause layoffs among the 12 million U.S. workers who owe their jobs to exports.