

Terms of Trade — Worksheet

Part A — The index, its drivers and its effects

This worksheet drills the terms of trade index calculation and the analysis of what drives the terms of trade and what changes in them do to the Australian economy.

Worked example. Export price index 120, import price index 96.

$ToT = (120 \div 96) \times 100 = 125 \rightarrow \text{an improvement (above 100)}$

Percentage change from a base of 100: $(125 - 100) \div 100 \times 100 = +25\%$.

"Improvement" and "deterioration" are the correct words for ToT movements — use them rather than just "up" and "down", and always relate the change back to export vs import prices.

Concept and calculation

1. Define the terms of trade and state the formula for the terms of trade index.

2. Calculate the terms of trade index for each year and state whether each is an improvement or deterioration relative to the base (100):

(a) export price index 125, import price index 100. _____

(b) export price index 108, import price index 120. _____

(c) export price index 140, import price index 112. _____

3. In year 1 the ToT index is 105; in year 2 it is 132. Calculate the percentage change and describe the movement. _____

Factors and effects

4. Explain how each of the following would affect Australia's terms of trade: (a) a surge in Chinese demand for steel; (b) a global glut of liquefied natural gas; (c) a rise in the price of imported manufactured goods.

5. Analyse the effects of a sustained improvement in the terms of trade on (a) national income, (b) the federal budget, and (c) the exchange rate.

6. "A terms of trade boom is good news for the whole economy." Discuss, noting at least one group or sector that may be disadvantaged.
