CHAPTER 1

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Since the beginning of the second half of the last century, the question of the behaviour of terms of trade, particularly for less developed countries (LDCs), has been gaining attention in the international arena. This issue has become more important since the movement of terms of trade has been regarded as a key index of the distribution of benefits from the international division of labour and the development prospects of the South. In recent years, volume of trade has been increasing very rapidly keeping in pace with the growth of the world economy. The growth of trade is also massive in the LDCs. Its impact has been felt in recent liberalisation process followed in such countries. The increase in openness of the economies and the importance of the traded sector in their GDPs have brought forward the significance of the role and behaviour of terms of trade. But any discourse about the international terms of trade should begin with its precise meaning.

Terms of trade, in the context of international trade, commonly refers to commodity terms of trade or net barter terms of trade (NBTT). It is an index of the amount of the foreign goods that a country can command. When a country exports one good and imports another its terms of trade is equal to the ratio of the price of exports to the price of imports. If it exports and imports more than one good then terms of trade is expressed as the ratio of the price indices of exports and imports. NBTT has no significance in one
period taken in isolation. Thus the change or the movement of NBTT is more important. When NBTT for a country improves then it can import more with each unit of export. There are different kinds of terms of trade with each one having a different interpretation. Gross barter terms of trade is measured by the ratio of the volume of imports and exports. When the balance of payments is zero, gross barter terms of trade coincides with net barter terms of trade. Even more interesting is the concept of the income terms of trade. It is obtained by multiplying the commodity terms of trade with the volume of exports. It measures the purchasing power of the exports or the capacity to import of the exports. Again, there are concepts like single and double factorial terms of trade. Single factorial terms of trade is measured by multiplying export productivity index with NBTT. It shows how much a unit of resource can buy in the domestic country. Thus if terms of trade falls but the domestic economy becomes more productive in the sense that it now uses less resources for each unit of export, then there is no reason to believe that the trading conditions have deteriorated for the country. Double factorial terms of trade is measured by the ratio of the labour (or, any other resource) productivity of the domestic country to the labour productivity of the foreign country. It measures the amount of foreign labour that may be purchased by one unit of domestic labour. Double factorial terms of trade for a country would thus deteriorate when the labour productivity in the foreign country increases more than the labour productivity in the domestic country. Unless otherwise specified, the present study uses terms of trade to refer to the commodity or net barter terms of trade.

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1 See Basu (1984).
The most controversial and debated issue regarding the long run behaviour of terms of trade is associated with the Prebisch-Singer (1950) hypothesis (hereafter P-S hypothesis). In terms of the hypothesis the LDCs or the periphery face deteriorating terms of trade in the long run in their trade with the developed countries. Although the focus of the P-S hypothesis was on terms of trade between the primary products and the manufactures, the explanations for the declining trend have been given in terms of the types of countries. This is because exports of the periphery consist mainly of primary products and exports of the manufactures are related to the centre. This finding came in the literature as a challenge to the classical prediction of a secular improvement in terms of trade of the primary products exported by the underdeveloped countries vis-à-vis the manufactured products exported by the industrialised countries.

In the classical theory of international trade, the equilibrium terms of exchange is determined by international supply and demand relations and there terms of trade provides the basis for the division of the gains from trade among the participating nations. Since the 1950s trade theories deal with both the short run and long run character of terms of trade. The short run aspect of it is derived from the “traditional theorem” based on the trade balance condition in which the determinants of terms of trade are derived from the asymmetric demand conditions. In the “Unequal Exchange theory” of Emmanuel (1972) and Lewis (1977), the determinants of the short run terms of trade are derived from the labour market conditions. The determinants of terms of trade in the long

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2 The ‘traditional theorem’ states that equilibrium value of the international terms of trade is determined by the equality between the value of demand for imports of the home country and the value of demand for imports by the foreign country. The theorem was developed by Johnson (1954), Prebisch (1959) and Singer (1964). See J.A.Ocampo (1986).
run are analysed by taking into consideration the determinants of capital accumulation. In these North-South models, the South coincides with a Lewis-type economy although characterisation of the North differs significantly. In the neoclassical (Solow) North in Findlay (1980), the long run value of terms of trade is determined from the condition of equilibrium of growth rates of the North (which is equivalent to the natural growth rate) and the South. The Southern growth rate depends upon the short run value of terms of trade since it determines the rate of profit of the South.

In the framework of North-South models, when short run value of terms of trade affects the rate of return to capital in the South, the process of capital accumulation affects the long run equilibrium values of the capital stocks of both regions. In a world with free and perfect mobility of capital, such capital accumulation also affects the inflow of foreign capital into the South. As the short run value of terms of trade is determined by the trade balance condition, the South can adopt suitable trade policies to influence the inflow of foreign capital. Thus North-South models can explain the role of terms of trade in generating funds for development in the South.

The role of terms of trade in affecting the income distribution of a society is no less important than influencing the development prospects of the South. The impact of terms of trade on income distribution is based on the Stolper-Samuelson theorem. Although the theorem is derived from the 2x2 Heckscher-Ohlin-Samuelson (HOS) structure, its applicability may remain valid for hybrid models which are a mix of Jones (1965) mobile factor and Jones (1971) specific factor trade models. This type of structure justifies the

\[^3\] It actually implies a Jones (1965) structure.
characteristics of the production and trade patterns of LDCs. When the labour market of
the South is decomposed into skilled labour and unskilled labour along with urban
unemployment in the latter, the question of the movement of the relative wages of the
unskilled is to be addressed in a liberalised trade regime.

Since 1960s interests have grown among the economists to study the basic theorems
of the 2x2 HOS model after incorporating nontraded goods in its structure. Given the
constraints imposed on the resources to be used in the production of tradeables and
nontradeables and the consumers' preferences distributed between them, the presence of
nontraded goods bears important implications in the context of the basic trade theoretic
results. Although the market for the nontraded good is cleared domestically, any
disturbance in this market may affect terms of trade by influencing the prices of the
traded goods. In the context of the developing economies terms of trade may be taken to
be endogenous since there are statistical evidences that could disregard the applicability
of the 'small country assumption' for the LDCs.

Since the controversy and debate over terms of trade have been triggered off by the
P-S hypothesis, any comprehensive study on terms of trade cannot overlook the long run
behaviour of terms of trade for the LDCs during the post World War years. P-S
hypothesis gave a warning to these countries regarding choices between outward looking
was interested in studying the behaviour of the terms of trade for the LDCs in the
liberalised trade regime. The empirical results of any case study for an individual

\[\text{See Lutz and Singer (1994)}\]
developing country would give the trend of terms of trade and it would also provide ample opportunity to understand the impact and role to be played by terms of trade in a developing country. It is also important to examine whether the terms of trade for a developing economy is endogenous or exogenous.

The world economy is being increasingly integrated with liberalised trade and investment regimes in developing economies. The role of terms of trade has now become more important in the context of the development process of LDCs. But there has remained a lack of comprehensive study which includes and integrates both the theoretical and empirical aspects of the terms of trade of such economies. So there is enough scope of research on this subject. It remains the task of the researcher to truly assess the role and behaviour of the terms of trade of a developing economy. This has provided the basic motivation for the initiation of our study. The present dissertation is a comprehensive exercise in examining the role and behaviour of terms of trade in the context of a developing economy.