

7.2 Trade, exchange rates and the balance of payments

Name: _____ Class: _____ Date: _____

Total: 36 marks

KEY WORDS terms of trade • comparative advantage • tariff
• depreciation • Marshall-Lerner condition • J-curve J

Objective

Calculate and interpret the terms of trade and opportunity costs, analyse protection with a tariff diagram, and evaluate current-account and exchange-rate policies at full IA2 essay standard.

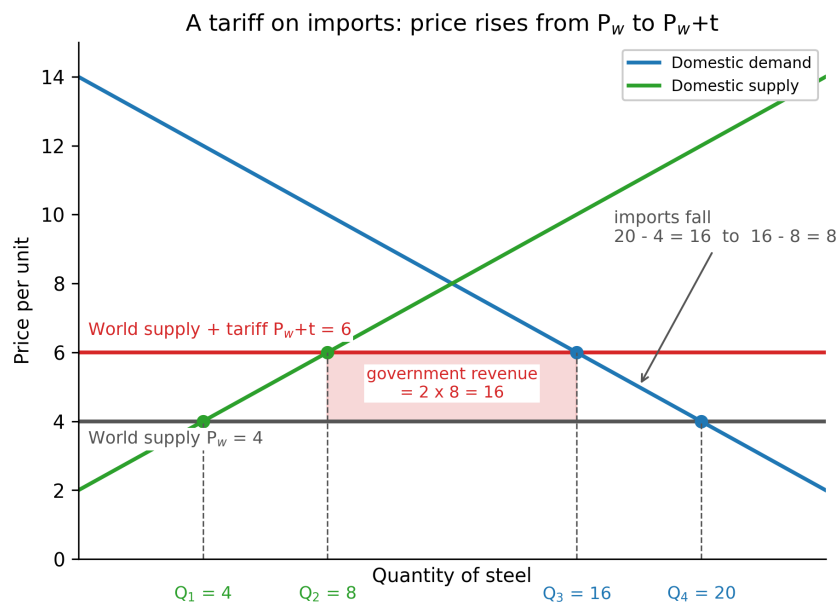
1 Key knowledge and worked examples

The **terms of trade** = (index of export prices / index of import prices) $\times$ 100. A rise is an “improvement”: each export unit buys more imports. Whether export *revenue* rises depends on how strongly quantities respond.

Worked example. In 2024 an economy’s export price index fell from 100 to 96 while its import price index fell from 100 to 98. $ToT = 96 / 98 \times 100 = 97.96 \approx 98.0$ – a deterioration of about 2%, because export prices fell faster.

Comparative advantage means lower opportunity cost, not greater speed. For two countries and two goods, compute each opportunity cost in the same units; a trade ratio between the two opportunity costs can benefit both.

A **tariff** raises the domestic price from the world price P_w to $P_w + t$: domestic output rises, consumption falls, imports shrink, and the government gains revenue of t times the new import quantity.



A **depreciation** lowers a floating currency's value; a **devaluation** is an official cut in a fixed rate. In the traditional initially balanced-trade model with perfectly elastic supply and full price pass-through, the **Marshall-Lerner condition** requires the magnitudes of export and import demand elasticities to sum to more than 1 for a trade-balance improvement. The **J-curve** is a possible initial worsening before later improvement, conditional on prices, contracts and quantity responses.

2 Practice

2.1 A country's export price index rises from 100 to 108 while its import price index rises from 100 to 112. Calculate the new terms of trade and state whether this is an improvement or a deterioration. [4]

2.2 Country P uses 5 worker-hours per phone and 10 per table; country Q uses 8 per phone and 8 per table. Calculate each country's opportunity cost of one phone and one table, state each comparative advantage, and judge whether trading at 1 phone for 1.2 tables benefits both. [6]

2.3 Using a domestic supply-and-demand diagram with a horizontal world supply, explain the effect of a quota that limits imports to less than the free-trade quantity on the domestic price and on government revenue. [6]

3 Exam-style questions

3.1 The fictional economy of Barokia has run a current-account deficit near 6% of GDP for five years, financed by selling government bonds to foreign investors. Its currency floats freely. Evaluate measures that could be taken to reduce Barokia's current account deficit. Refer to Barokia in your answer. [20]