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ARTICLES

Terms of Trade and the Developing Countries

By Professor Dr. Alfred Kruse, Berlin

Time and again spokesmen of the developing countries point out that the so-called terms of trade are constantly changing to their disadvantage and in favour of the industrialised countries; development aid—so it is argued—is being completely neutralised by this harmful trend.

What is there in this argument? First of all, the use of "terms of trade" as a yardstick needs explaining. It is thought to provide a statistical means of assessing any changes in the profitability of a country's foreign trade over a given period. For this purpose the relationship between the prices of export goods is compared with that for import goods at various points in time. An algebraic formula expressing this would be

$$\left(\frac{Px_1}{Pm_1} : \frac{Px_0}{Pm_0} \right) \cdot 100$$

where Px is the index of export prices; Pm the index of import prices; 0 the base year; and 1 represents a later date. If, for instance, export prices have doubled and import prices trebled between the two dates, the terms of trade (expressed as an index) would have dropped from 100 to 66:

$$\left(\frac{200}{300} : \frac{100}{100} \right) \cdot 100 = 66$$

A fall is generally regarded as a "deterioration" and a rise as an "improvement" in the terms of trade, a deterioration being considered as producing an unfavourable and an improvement a favourable impact on a national economy. This assessment assumes that in the case of a "deterioration"—that is when the index is lower than at the previous date—the same amount of export goods procures a smaller quantity of import goods, or in other words more exports must be supplied for the same amount of imports. As a result, it is argued, the terms of trade would "improve" correspondingly for the partner countries.

Since the seventies of last century the terms of trade index has fallen almost uninterruptedly as far as the agricultural and raw material producing countries are concerned. For the most recent years the Statistical Yearbook of the United Nations shows that between 1950 and 1963 the index for the developing countries dropped from 100 to 87; this would mean a "deterioration" by 13%. In assessing these figures it should, however, be noted that statistical values are not always entirely reliable, particularly in case of a remote base year. Furthermore over the years, foreign trade undergoes not only quantitative but also qualitative changes: new products emerge, the quality of

old ones is being improved, and there are many changes in the list of goods involved in foreign trade. The import or export price index cannot register this at all or only to a limited extent. Yet these two indices are used to determine the terms of trade. It has to be kept in mind that farm and mining raw materials have undergone insignificant, if any, changes in quality in the course of time. On the other hand, it is an essential feature of industrial products that their quality is constantly being improved. This applies to both industrial consumer and capital goods. But the longer life and greater efficiency of machines is as little reflected in the price index as is the fast improving quality of durables (television sets, washing machines, motor cars, etc.).

Despite this reservation the fall in the indices of the terms of trade of the developing countries, i.e. the "deterioration" of the terms of trade is very impressive. Yet caution is required in equating "fall" and "deterioration". There is little sense in trying to read too much into it, which becomes clear when the causes of index changes are examined. Internal reasons for an "improvement" or a "deterioration" may be changes in the foreign exchange rates, in the demand for imported goods or in the supply of export goods.

If, other things remaining equal, the demand for goods to be imported increases the terms of trade will "worsen"; if fewer goods from abroad are wanted, the terms will "improve". Demand for capital goods which have to be imported in order to industrialise a country may, e.g. increase and contribute to a rise in the price of capital goods in the industrialised countries, which, other factors remaining unchanged, results in a worsening of the terms of trade. But the internal cause of such higher demand may well be a change in a country's economic structure (e.g. its industrialisation) or the fact that the population's real income has gone up. Therefore a "deterioration" in the terms of trade alone does not justify the assertion that this is good or bad for the economy; it may sometimes even be a symptom of an improvement in the economic situation. But if the terms of trade index has fallen because the trading partner restricted his imports then, indeed, the "fall" may be equated with "deterioration".

If the supply of export goods rises or falls the terms of trade, other things remaining equal, will "worsen" or "improve", respectively. A rise in internal supplies and thus "worsening" of terms of trade may also be a sign of either an improved or a worsened economic situation. If the price level of export goods has

dropped this may be due to costs having gone down because agricultural production methods have improved or there has been a technological advance; or else taxation policies may have enforced higher exports. On the other hand, lower internal supply and the resulting "improved" trade terms may be due e.g. to higher internal consumption and a better living standard or a poor harvest. Again neither the improvement nor deterioration of a country's foreign trade situation can be assessed from the terms of trade.

By rejecting the terms of trade as a yardstick of the impact of foreign trade on a country's prosperity we do not deny that a declining terms of trade index may indicate an unfavourable trend for the developing countries. The decisive factor is the drop in the price of their exports. But if the trend is unfavourable for the developing nations this is only to a very small degree due to a protectionist policy of the industrialised countries. Certainly, import restrictions lead to a fall in the index (a deterioration) of the terms of trade of the exporting countries. But the extent and the intensity of such trade barriers is often exaggerated.

Apart from the consequences of misguided price arrangements (e.g. through international commodity agreements) there are three main reasons for drop-

ping raw material prices and thus for worsening terms of trade: 1) the industrialised countries have devised processes enabling them to replace the natural raw materials of developing countries by their own products (e.g. rubber, textile fibres, aluminium and synthetic materials); 2) in the case of many farm products demand in industrialised countries becomes considerably less elastic, and elasticity often drops to near zero, as the national income increases. This means that e.g. sales of tropical produce such as coffee, cocoa or bananas grow at a lower ratio than incomes; 3) on the other hand it has become possible to make mining or the production of agricultural raw materials more efficient. A case in point are new methods of growing tropical plants and fruit and combatting plant diseases.

Constant pursuit of "better" terms of trade and of doubtful international price arrangements is not the best way of using trade policies to help developing countries. It would be more advisable to do away with existing discrimination against the export trade of developing countries, to lower tariffs and other trade barriers against their processed foods and industrial goods to the level imposed on their raw material exports, and to make a serious start with dismantling the protective wall surrounding mining and agriculture in the industrialised countries. At least no one should do the opposite.

Nigeria Joins the EEC — Chance of Aid by Trade

By Rütger Berchem, Aachen

The foundation of the European Economic Community in 1958 had been watched suspiciously by numerous developing countries. After all the traditional relations between some EEC member states and certain developing countries, particularly in Africa, was leading to a privileged position of the latter. In case of an association these countries, that in the meantime had become independent, received additional multilateral aid by the Development Fund for the associated territories of EEC countries, which is financed through contributions of all member states. In the long run the privileged position conceded to these countries could become important in the European market.

Before the establishment of the EEC especially the Netherlands and the Federal Republic of Germany levied only low duties, or none at all, on many products typical for developing countries, thus e.g. tropical products. The French market was largely reserved for the members of the Communauté Française. Consequently the introduction of a common external customs tariff of the EEC has led to a considerable increase of tariff rates for important products of the developing countries, while the privileged position of the already associated African countries remained unimpaired or could be extended even. This trend has been watched distrustfully by the EEC members' traditional supplier countries, also by the Latin American states. So far pressing difficulties have been

mostly avoided and the EEC market remains accessible to these traditional suppliers since the EEC commission granted duty-free quotas. These duty-free quotas have to be applied for by the importing countries and, moreover, the granting of them is a discretionary clause. Therefore this regulation does not offer long-term security.

Besides the EEC members' market is exerting a steadily increasing attraction on the developing countries. Since 1958 its absorbing capacity has grown more than that of the other traditional sales areas. Independent of suppositions expressed time and again that negative effects are dominating when customs unions are established, since such new economic areas would be inclined to isolate themselves from world trade, there is a growing interdependence between the EEC and world trade—also with regard to trade with developing countries. Among the industrial nations only Japan has surpassed the growth rates of the exchange of goods in terms of value. Table 1 is showing the last years' trend.

In spite of the generally positive development of trade with the developing countries the exchange of goods among industrialised states increased even more. The developing countries' relative share in world trade has steadily declined during the past years. Thus they are still facing problems, and thus the questions of the EEC foreign trade policy are im-