PENANG SANGAM HIGH SCHOOL

LESSON NOTES-WEEK 26

Subject: Commercial Studies **Year:** 10

Strand: 3 **Sub Strand:** 3.4 – International Economics

Content Learning Outcome: - Explore and demonstrate measurements of Balance of Payment.

<u>Lesson Notes:</u>

<u>Terms of Trade (T.O.T):</u> Price ratio at which two countries are prepared to exchange goods, must therefore lie somewhere between the two countries domestic cost.

Balance of trade: A country's exports minus its imports; the largest component of a country's balance of payments.

Formula for Calculating Terms of Trade

$$\text{Terms of Trade} = \frac{\text{Index Of Export Price}}{\text{Index Of Import Price}} \text{ X } \frac{100}{1}$$

<u>For Example:</u>

<u>Question</u>

Base year 2006: 100. Calculate the T.O.T for:

i. 2007
i. 2008

Year	Export	Import
2007	105	90
2008	80	102

<u>Solution:</u>

i $$\text{Terms of Trade} = \frac{\text{Index Of Export Price}}{\text{Index Of Import Price}} \text{ X } \frac{100}{1}$$

$$= \frac{105}{90} \text{ X } \frac{100}{1}$$

= 116.67(**favourable)**

ii Terms of Trade $= \frac{\text{Index Of Export Price}}{\text{Index Of Import Price}} \times \frac{100}{1}$

$= \frac{80}{102} \times \frac{100}{1}$

$= \underline{78.43}$ **(unfavourable)**

Interpreting Terms of trade

A rise in TOT index for a particular year indicates a favourable movement. A favourable movement in T.O.T. maybe the result of:

- ✓ Export price increasing more than import price
- ✓ Export price increasing while import price remains constant
- ✓ Export price remains constant while import price falls
- ✓ Import price falls faster than export price.

Class Activity

1. The table given below shows the index of export and import of goods and services for **Economy Y** for the year 2008-2009.

Export and Import Price Index for Economy Y

Year	Export Price Index	Import Price Index
2008	134	145
2009	204	165

Base year 2007: 100

Calculate the **terms of trade** for the years 2008 and 2009.

2. The table given below shows terms of trade for **Economy Y** for the year 2005-2007.

Export and Import Price Index for Economy Z

Year	Export Price Index	Import Price Index	Terms of Trade
2005	120	130	92.31
2006	110	148	74.32
2007	130	115	113.04

Base year 2004: 100

Use the table given below and your knowledge to answer the following questions:

i. Explain the terms of trade for the years 2006 and 2007

ii. State the formula for calculating terms of trade

iii. State **one** way of improving a country's terms of trade.

Balance of Payment

Is a record of transaction between a country and the rest of the world.

BOP = Balance of Current + Balance of Capital Account

There are two main sections of balance of payments. These are:

1. Current account
2. Capital account

Current Account

- Records the imports and exports of goods and services
- Regarded as the most important section of balance of payment because it measures nations earning and spending abroad.
- It is divided into two sections:

1. Visible trade (merchandise trade) – represents the export and imports of goods that can be seen and touched.eg cars, furniture, food and machinery.

Balance Of Trade = Visible Export – Visible Import

2. Invisible trade – refers to the export and import of services like banking, insurance, tourism, transport and also includes:

- Investment income such as profit, rent, interest, dividend
- Government expenditure overseas
- Transfer payment which includes gifts

Invisible Export (Credit)

- Are those invisible items that brings foreign exchange
- For example tourist in Fiji, rent. Interest, dividend earn abroad, transfer income from overseas company are treated as credit items.

Invisible Import (Debit)

- Are using of foreign exchange to purchase invisible items
- For example purchase of insurance policy from foreign company, profit interest, dividend, and rent paid abroad, government expenditure overseas, transfer payments made abroad are treated as debit items.

Current Account =	Visible Trade	+	Invisible Trade
	= (Visible Export – Visible Import) + (Invisible Export – Invisible Import)		

Example:

Visible import \$105m
Visible export \$225m
Invisible export \$210m
Invisible import \$150m

Required:

Calculate:

1. Balance of trade
2. Current account balance

Solution:

1. Balance Of Trade = Visible Export – Visible Import

   = \$225m - \$105m

   = **\$120m**

2. Current Account = Visible Trade + Invisible Trade

   = (Visible Export – Visible Import) + (Invisible Export – Invisible Import)

   = (\$225m - \$105m) + (\$210m - \$150m)

   = **\$ 180m**

Capital Account

- This records the movement of money into and out of the country.
- For all the purposes except for payment of goods and services
- The capital account records all the following international transaction between both private and public organization

  1. International loan
  2. Direct investment such as purchasing of building, factory, land etc.
  3. Monetary investment and purchase of securities such as stocks and bonds.

Capital inflow – Capital Outflow

Class Activity

1.

Use the information given below for the **Economy Z** to answer the questions that follow.

Economy Z

	$m
Capital inflow	76
Import of services	13
Capital outflow	57
Export of goods	45
Export of services	80
Import of goods	50

a. Calculate the following:

- i. Balance of Trade
- ii. Balance of Invisible
- iii. Balance of Current Account
- iv. Balance of Capital Account
- v. Balance of Payments

b. Why would there be a deficit Balance of Payments?

2.

Use the information given below for the **Economy Y** to answer the questions that follow.

Economy Y

	$m
Profits earned abroad	100
Tourism receipts	150
Interest paid abroad	105
Direct investment in the economy	175
Dividends paid abroad	50

Calculate the following:

- i. Invisible exports
- ii. Invisible imports
- iii. Capital inflow