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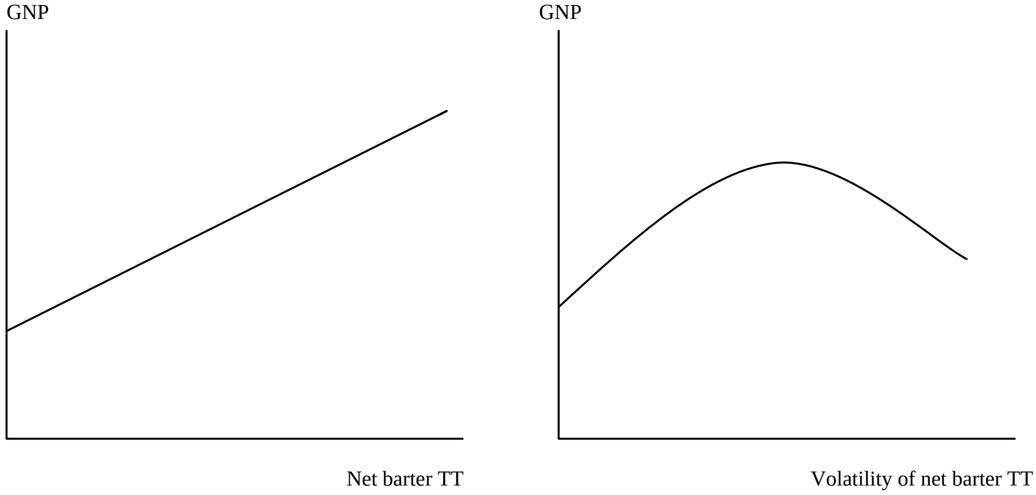
Impact of a change in net barter terms of trade and their volatility on GNP:



Changes in the net barter terms of trade affect the size of GNP, either by inflating it (if TT improve) or shrinking it (if TT fall).

The volatility of TT has another effect – creates shocks and uncertainty. Shocks may affect the competitiveness and sustainability of the economy – a sudden price boom may appreciate the domestic currency, generate inflation, promote excessive spending and in the next round deteriorate foreign reserves and the current account. A sudden bust may deteriorate the current account and foreign reserves and force an inflationary domestic monetary policy to compensate for the sudden contraction of the economy. Uncertainty driven by price volatility also affects business expectations and tends to reduce investment.

Export gains = export expansion x index of terms of trade.

Economies that have a diversified export structure and whose exports are income and price elastic not only export more, but also the NBTT of their exports do not decline and are not volatile.

[Note: not account for productivity gains and specific industrial dynamics; hence, deterioration of NBTT is product associated, and is a bad thing].

Why do poor countries suffer more from the instability of NBTT?

1) The size (huge), direction (decline) and volatility (high) of price shocks associated with LDCs exports;
2) LDCs have a narrow export base associated with a narrow productive base;

3) LDCs are import dependent, in particular for investment goods (intermediate ad capital goods, as well as some fundamental wage goods). Hence they have no easy substitutes for imports – when their NBTT go bust they either contract their economy (including their productive capacity), or go into debt and macroeconomic instability;
4) Trade revenues often form a larger part of the fiscal revenue – either true taxation on export revenues, trade rents accruing to state controlled marketing boards, and/or import duties (and also export levies). If trade revenues, and so imports, collapse fiscal revenue also tends to be strongly and negatively affected.
5) There are fundamental political economy problems with the “sterilisation” of the extra trade revenue during the boom periods – difficulties to increase taxation, the allocation of income (who gets the extra revenue, the producer or the middle man). Both affect the nature of the shock and the ability of the economy to deal with it.
6) Lack of absorptive capacity in investment terms – this creates added difficulties to translate increased trade revenue into investment to diversify the economy.

Conclusions:

1) Improvement in the NBTT increases GNP in the following year;
2) Variability (volatility) have an immediate negative impact due to uncertainty and shocks;
3) Even if the general long-term trend of the NBTT is improving, short-term excessive volatility may cancel out the benefits of favourable NBTT;
4) There are circular influences = volatility – uncertainty – less investment – narrow pattern of production and trade – declining GDP – low absorptive capacity – volatility - …

A large shock on NBTT yields an immediate negative impact due to volatility; a lagged one year impact due to deterioration of trade revenues; and a circular (second-third year) impact due to declining GNP growth rates.