



Worksheet 25.1

Deteriorating Terms of Trade and the Current Account Balance

Terms of trade is a term that is often misunderstood by IB Economics students. Simply put, a nation's terms of trade refers to the relative price of a country's exports to its imports.

When a country's imports increase in price, while the value of its exports stays the same, the country's terms of trade are said to deteriorate. As a nation experiences deteriorating terms of trade, it finds itself moving towards a deficit in its current account, meaning that expenditures on imports are growing more than income from exports, also called a trade deficit.

The United States has run trade deficits for most years since 1970. Since 2004 the US has annually spent over \$600 billion MORE on imports than it earned from the sale of its exports. (Balance of trade data going back to 1960 can be found [here](#)).

Usually, when a country enters a recession, it would be expected that its balance of trade would improve, since households demand fewer imports and domestic inflation decreases making the country's products more attractive to foreign households. In fact, in 2008, when the US entered its current recession, its trade deficit actually decreased. Recently, however, due to the weakness of many of its trading partners and a deterioration in terms of trade, America's recession is accompanied by a deepening trade deficit. From this *Wall Street Journal* [article](#) read the first three paragraphs.

Questions:

1. How did rising oil prices lead to an increase in America's trade deficit?
2. What determines demand for American exports in the rest of the world? Why is demand for American goods and services falling even as their prices decline due to deflation in the US?
3. Where does America get the money to buy hundreds of dollars more in imports than it sells in exports? What do foreigners do with all the US dollars they earn from their enormous trade *surplus* with the US?
4. Why doesn't the US government simply place tariffs or quotas on imports to try and achieve more balanced trade with the rest of the world? Is this an appropriate response to a trade deficit?