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Terms of trade and Russian economic development☆

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Abstract

The paper discusses economic development trends in Russia in late 2014 and 2015 and reviews the basic mechanisms of how changes in the terms of trade affect the economic development of countries from a historical perspective and with a particular focus on those changes in the Russian economy that occurred in late 2014 and 2015. The authors demonstrate that structural reforms aimed at diversification of production and exports are necessary for sustainable economic development, for social stability and for reducing the impact of variability in the terms of trade on the Russian economy. During periods of instability in the government agenda's measures for the real and financial sectors, it is necessary not only to compensate economic agents losses caused by changes in the terms of trade but also to improve the economic structure and to develop and enhance the stability of the financial markets.

JEL: E0, O1, O4, F1.
Keywords: economic development, terms of trade, GDP, GDI.

1. Introduction: Volatility of the terms of trade and economic development

Terms of trade[1] have historically been one of the most important factors in economic development (see Broadberry and O'Rourke, 2013). With the emer-

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[1] Terms of trade are normally defined as the ratio of an index of a country's export prices to an index of its import prices. In a simplified case, if a country exports one commodity and imports another one, its terms of trade can be described by a simple ratio of export prices to import prices. In a model that involves many countries partnering in trade—and multiple exported and imported items—the terms of trade for a given country are described as the ratio of its per unit value of exports to that of imports (see, e.g., Obstfeld et al., 1996).

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gence of modern statistical methods in the 20th century, these regularities became the focus of many in-depth studies (Basu and McLeod, 1991; Mendoza, 1997; Bleaney and Greenaway, 2001; Bernstein, 2009). Thus, the high growth rates in world prices for Canada's top exports (non-ferrous metals, cereal grains) over the period spanning the 1940s to the 1970s led to that country's economic rise (Baldwin and Macdonald, 2012), whereas plummeting coffee prices in the 1930s are considered a major cause of the crisis that Brazil's economy took nearly a decade to overcome (Baer, 2014). Australia's improving terms of trade over several periods (including rising prices of wool and cereal grains over the 1922–1925 period, rising prices for wool and agricultural products over the 1944–1951 period, and rising prices for iron ore and coal in 2004–2011) resulted in economic growth at an impressive rate during each period (Atkin et al., 2014).

Importantly, even if changes in terms of trade *per se* neither improve nor worsen a country's macrodynamics, they represent one of the strongest external factors that can accelerate transformational shifts in a country's sectoral structure and change the course of political and institutional reforms. Thus, the drop in world oil prices in the early and mid-1980s was the major trigger of the subsequent chain of events in the USSR,[2] whereas the steady deterioration of China's terms of trade in both the 1990s and 2010s led that country to search for a new economic growth model oriented more toward the domestic market than to exports (Sinelnikov, 1995; Gaidar, 2006). The principal mechanism whereby a country's terms of trade can yield such a strong impact on the level and rate of economic development is primarily linked to production. As has vividly been illustrated in many classic academic studies (Mundell, 1957; Markusen, 1983; Kohli, 2004), terms of trade are a quantitative measure of production technology that can also arbitrarily be termed "international trade" and that determine the quantity of goods and services that can be purchased (imported) by a national economy in exchange for the goods and services supplied (exported) by it. In other words, terms of trade, similar to traditional technologies in the real sector, quantitatively determine the possibility of transforming one type of welfare into another. Over the past two centuries, the role of international trade in production has been steadily on the rise. This role was further enhanced by the significantly increased openness of most countries' economies across the globe and by the increasing speed and depth of information dissemination regarding foreign markets and declining transportation costs as a result of technological progress (including the unprecedented drop in prices following the invention of the steam engine), as well as the lowering of institutional costs and barriers (Harrison, 1996). Another important factor is the impressive evolution of production-linked aspects of trade — from trade in final products that are produced entirely in a national territory to trade in added value and intensive incorporation of international producers into globally distributed added value chains — that have rapidly boosted the role of foreign goods in domestic consumption (Bernard et al., 2007).

[2] It is important to note in this connection that one of the major causes of the economic problems faced by the USSR in the 1980s was the Soviet leadership's low level of economic competence (see Gaidar, 2006).