

S. A. Özga. *The Rate of Exchange and the Terms of Trade*. New Brunswick, New Jersey / London: Aldine Transaction, 2008. 116 pages. Paperback. Price not given.

S. A. Özga aims to provide a concise outline of the theory behind the rate of exchange and the terms of trade, in textbook fashion at an elementary level. The terms of trade are defined as the ratio of the money prices of imports and exports, while the balance of trade is the ratio of the value of exports to imports. The analysis in the book, as pointed out by the author, is limited in several ways. First, it does not go beyond defining and exploring relations between limited concepts, and does not touch upon ways of testing or proving any concepts. Secondly, the book deals with only the theory of ratios of exchange as they pertain to international trade. Yet, the discussion in the book is quite focused, which makes it easy to follow.

According to the author, if the price is not fixed by law, or by the buyer or seller involved in the purchase, the price will be determined by forces of supply and demand. The shortest list of the parameters that determine the form of demand curves in an aggregative model would include the price of importables as well as exportables and the level of aggregate spending (also known as absorption). The supply function, however, is determined by the prices of factors of production as well as by production techniques. Özga's analysis begins with a simple analysis of the demand and supply relations in international trade. The next step of the analysis would be to examine the factors that determine supply and demand.

In an aggregative model of international trade, the price and volume of imports are determined by the relations of supply and demand for importables at home and abroad, while the price and volume of exports are determined by the relations of supply and demand for exportables abroad and at home.

However, there is nothing in the technique to determine equilibrium in the foreign exchange market. Equilibrium of demand and supply for imports and for exports does not imply that the values of imports and of exports are equal to the balance on the capital account. There is no relation or mechanism in the terms of trade and balance of trade identities to allow for the equilibrium of balance of payments. Since the supply of foreign exchange is not inexhaustible, in the long run, the balance of trade ratio must be formulated accordingly. As such, it cannot be considered as a variable in the model being developed. Therefore, other variables and relations must be introduced into the model. Changes in the money supply result in changes in the level of absorption. However, this line of analysis lost favour after the First World War, when monetary policies ceased giving priority to external balances and maintaining exchange rates. Although no longer quite so useful as a tool of analysis, there are cases, such as devaluations, where the analysis can benefit from this aspect of the demand and supply model.

In the Keynesian analysis of international trade, as opposed to the classical theory discussed earlier, output is taken as a variable to be determined and not as an exogenous point, as dictated by assumptions of full employment, as well as the assumption that absorption in money terms and price levels are determined by money supply. These issues are discussed by the author in the chapter titled "The Real Income Effect". The reader is made aware of the view that the supply-and-demand tool of analysis is useful to grasp one aspect of what actually takes place in international trade, while the real-income-effect tool is useful to look at something quite different. This is precisely why

both tools can be used together to help better understand and gain a valuable insight into the analysis of international trade.

In the chapter on “Rate of Exchange”, Ozga touches upon some of the factors that determine the rate of exchange, by removing these from the equation; by imposing the *ceteris paribus* condition or imposing additional relationships to convert parameters into variables. The reader may notice that while the supply-and-demand approach uses a model with prices of traded goods as variables and absorption in money terms as a parameter, the absorption approach uses a model where prices of traded goods are parameters and absorption is a variable. Thus the models complement each other.

The terms of trade offer an indication of how the gains from trade are distributed or divided among partner countries. In the last chapter, “Continuous Adjustments”, the author applies the method of comparative statics to continuous changes in an attempt to answer the question of what tendencies in the balance of payments of a country may result from growth, and their impact on rate of exchange.

A discussion about the method of comparative statics applied to continuous displacements wraps up the remaining questions. Theoretical work on tendencies in the balance of payments, and any adjustments in the rate of exchange, is sparse. So far, the growth theory of international trade does not incorporate intertemporal relations, and the theory of balance of payments adjustments is a short-run theory. The balance of payments can not be in disequilibrium over the long-run, so some mechanism must exist for any deviations from equilibrium to be corrected. The author deals with two questions here; one, what adjustments in the rate of exchange are required to maintain external balance, given that internal balance is assured? Two, what adjustments in the terms of trade do the conditions of balance (internal as well as external) imply? The terms of trade are shown by the author to behave in the same way as the rate of exchange. It is shown that the rate of exchange is influenced by variations in real income, and prices, while adjustments in the system are governed by demand and income elasticities.

This volume has useful information and insights on the rates of exchange and the terms of trade, not only for students of international trade but also for the general reader, presented in a logical and concise fashion.

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