



2: International Flow of Funds

International business is facilitated by markets that allow for the flow of funds between countries. The transactions arising from international business cause money flows from one country to another. The balance of payments is a measure of international money flows and is discussed in this chapter.

Financial managers of MNCs monitor the balance of payments so that they can determine how the flow of international transactions is changing over time. The balance of payments can indicate the volume of transactions between specific countries and may

even signal potential shifts in specific exchange rates.

The specific objectives of this chapter are to:

- explain the key components of the balance of payments,
- explain how international trade flows are influenced by economic factors and other factors, and
- explain how international capital flows are influenced by country characteristics.

Balance of Payments

The **balance of payments** is a summary of transactions between domestic and foreign residents for a specific country over a specified period of time. It represents an accounting of a country's international transactions for a period, usually a quarter or a year. It accounts for transactions by businesses, individuals, and the government.

A balance-of-payments statement can be broken down into various components. Those that receive the most attention are the current account and the capital account. The **current account** represents a summary of the flow of funds between one specified country and all other countries due to purchases of goods or services, or the provision of income on financial assets. The **capital account** represents a summary of the flow of funds resulting from the sale of assets between one specified country and all other countries over a specified period of time. Thus, it compares the new foreign investments made by a country with the foreign investments within a country over a particular time period. Transactions that reflect inflows of funds generate positive numbers (credits) for the country's balance, while transactions that reflect outflows of funds generate negative numbers (debits) for the country's balance.

Current Account

The main components of the current account are payments for (1) merchandise (goods) and services, (2) factor income, and (3) transfers.

Payments for Merchandise and Services. Merchandise exports and imports represent tangible products, such as computers and clothing, that are transported between countries. Service exports and imports represent tourism and other services, such as legal, insurance, and consulting services, provided for customers based in other countries. Service exports by the United States result in an

inflow of funds to the United States, while service imports by the United States result in an outflow of funds.

The difference between total exports and imports is referred to as the **balance of trade**. A deficit in the balance of trade means that the value of merchandise and services exported by the United States is less than the value of merchandise and services imported by the United States. Before 1993, the balance of trade focused on only merchandise exports and imports. In 1993, it was redefined to include service exports and imports as well. The value of U.S. service exports usually exceeds the value of U.S. service imports. However, the value of U.S. merchandise exports is typically much smaller than the value of U.S. merchandise imports. Overall, the United States normally has a negative balance of trade.

Factor Income Payments. A second component of the current account is **factor income**, which represents income (interest and dividend payments) received by investors on foreign investments in financial assets (securities). Thus, factor income received by U.S. investors reflects an inflow of funds into the United States. Factor income paid by the United States reflects an outflow of funds from the United States.

Transfer Payments. A third component of the current account is transfer payments, which represent aid, grants, and gifts from one country to another.

Examples of Payment Entries. Exhibit 2.1 shows several examples of transactions that would be reflected in the current account. Notice in the exhibit that every transaction that generates a U.S. cash inflow (exports and income receipts by the United States) represents a credit to the current account, while every transaction that generates a U.S. cash outflow (imports and income payments by the United States) represents a debit to the current account. Therefore, a large current account deficit indicates that the United States is sending more cash abroad to buy goods and services or to pay income than it is receiving for those same reasons.

Actual Current Account Balance. The U.S. current account balance in the year 2006 is summarized in Exhibit 2.2. Notice that the exports of merchandise were valued at \$1,019 billion, while imports of merchandise by the United States were valued at \$1,836 billion. Total U.S. exports of merchandise and services and income receipts amounted to \$2,056 billion, while total U.S. imports amounted to \$2,793 billion. The bottom of the exhibit shows that net transfers (which include grants and gifts provided to other countries) were $-\$54$ billion. The negative number for net transfers represents a cash outflow from the United States.

Exhibit 2.2 shows that the current account balance (line 10) can be derived as the difference between total U.S. exports and income receipts (line 4) and the total U.S. imports and income payments (line 8), with an adjustment for net transfer payments (line 9). This is logical, since the total U.S. exports and income receipts represent U.S. cash inflows while the total U.S. imports and income payments and the net transfers represent U.S. cash outflows. The negative current account balance means that the United States spent more on trade, income, and transfer payments than it received.

Capital and Financial Accounts

The capital account category has been changed to separate it from the financial account, which is described next. The capital account includes the value of financial assets transferred across country borders by people who move to a different country. It also includes the value of nonproduced nonfinancial assets that are transferred across country borders, such as patents and trademarks. The sale of patent rights by a U.S. firm to a Canadian firm reflects a credit to the U.S. balance-of-payments ac-

Exhibit 2.1 Examples of Current Account Transactions

International Trade Transaction	U.S. Cash Flow Position	Entry on U.S. Balance-of-Payments Account
J.C. Penney purchases stereos produced in Indonesia that it will sell in its U.S. retail stores.	U.S. cash outflow	Debit
Individuals in the United States purchase CDs over the Internet from a firm based in China.	U.S. cash outflow	Debit
The Mexican government pays a U.S. consulting firm for consulting services provided by the firm.	U.S. cash inflow	Credit
IBM headquarters in the United States purchases computer chips from Singapore that it uses in assembling computers.	U.S. cash outflow	Debit
A university bookstore in Ireland purchases textbooks produced by a U.S. publishing company.	U.S. cash inflow	Credit
International Income Transaction	U.S. Cash Flow Position	Entry on U.S. Balance-of-Payments Account
A U.S. investor receives a dividend payment from a French firm in which she purchased stock.	U.S. cash inflow	Credit
The U.S. Treasury sends an interest payment to a German insurance company that purchased U.S. Treasury bonds one year ago.	U.S. cash outflow	Debit
A Mexican company that borrowed dollars from a bank based in the United States sends an interest payment to that bank.	U.S. cash inflow	Credit
International Transfer Transaction	U.S. Cash Flow Position	Entry on U.S. Balance-of-Payments Account
The United States provides aid to Costa Rica in response to a flood in Costa Rica.	U.S. cash outflow	Debit
Switzerland provides a grant to U.S. scientists to work on cancer research.	U.S. cash inflow	Credit

count, while a U.S. purchase of patent rights from a Canadian firm reflects a debit to the U.S. balance-of-payments account. The capital account items are relatively minor compared to the financial account items.

The key components of the financial account are payments for (1) direct foreign investment, (2) portfolio investment, and (3) other capital investment.

Direct Foreign Investment. Direct foreign investment represents the investment in fixed assets in foreign countries that can be used to conduct business operations. Examples of direct foreign investment include a firm's acquisition of a foreign company, its construction of a new manufacturing plant, or its expansion of an

Exhibit 2.2 Summary of U.S. Current Account in the Year 2006 (in billions of \$)

(1)	U.S. exports of merchandise	+	\$1,019
+ (2)	U.S. exports of services	+	411
+ (3)	<u>U.S. income receipts</u>	<u>+</u>	<u>626</u>
= (4)	Total U.S. exports and income receipts	=	\$2,056
(5)	U.S. imports of merchandise	−	\$1,836
+ (6)	U.S. imports of services	−	341
+ (7)	<u>U.S. income payments</u>	<u>−</u>	<u>616</u>
= (8)	Total U.S. imports and income payments	=	\$2,793
(9)	Net transfers by the U.S.	−	\$54
(10)	Current account balance = (4) − (8) − (9)	−	\$791

existing plant in a foreign country. In 2006, the United States increased its direct foreign investment abroad by \$248 billion, while non-U.S. countries increased their direct foreign investment in the United States by \$185 billion.

Portfolio Investment. Portfolio investment represents transactions involving long-term financial assets (such as stocks and bonds) between countries that do not affect the transfer of control. Thus, a purchase of Heineken (Netherlands) stock by a U.S. investor is classified as portfolio investment because it represents a purchase of foreign financial assets without changing control of the company. If a U.S. firm purchased all of Heineken's stock in an acquisition, this transaction would result in a transfer of control and therefore would be classified as direct foreign investment instead of portfolio investment. In 2006, the U.S. net purchases of foreign stocks were \$129 billion, while its net purchases of foreign bonds were \$149 billion. Non-U.S. net purchases of U.S. stocks were \$114 billion in 2006, while non-U.S. net purchases of U.S. bonds were \$507 billion.

Other Capital Investment. A third component of the financial account consists of other capital investment, which represents transactions involving short-term financial assets (such as money market securities) between countries. In general, direct foreign investment measures the expansion of firms' foreign operations, whereas portfolio investment and other capital investment measure the net flow of funds due to financial asset transactions between individual or institutional investors.

Errors and Omissions and Reserves. If a country has a negative current account balance, it should have a positive capital and financial account balance. This implies that while it sends more money out of the country than it receives from other countries for trade and factor income, it receives more money from other countries than it spends for capital and financial account components, such as investments. In fact, the negative balance on the current account should be offset by a positive balance on the capital and financial account. However, there is not normally a perfect offsetting effect because measurement errors can occur when attempting to measure the value of funds transferred into or out of a country. For this reason, the balance-of-payments account includes a category of errors and omissions.

International Trade Flows

Canada, France, Germany, and other European countries rely more heavily on trade than the United States does. Canada's trade volume of exports and imports per year

is valued at more than 50 percent of its annual gross domestic product (GDP). The trade volume of European countries is typically between 30 and 40 percent of their respective GDPs. The trade volume of the United States and Japan is typically between 10 and 20 percent of their respective GDPs. Nevertheless, for all countries, the volume of trade has grown over time. As of 2006, exports represented about 18 percent of U.S. GDP.

HTTP://

<http://www.whitehouse.gov/fsbr/international.htm>
Update of the current account balance and international trade balance.

HTTP://

<http://www.ita.doc.gov/td/industry/otea>
An outlook of international trade conditions for each of several industries.

Distribution of U.S. Exports and Imports

The dollar value of U.S. exports to various countries during 2006 is shown in Exhibit 2.3. The amounts of U.S. exports are rounded to the nearest billion. For example, exports to Canada were valued at \$230 billion.

The proportion of total U.S. exports to various countries is shown at the top of Exhibit 2.4. About 23 percent of all U.S. exports are to Canada, while 13 percent of U.S. exports are to Mexico.

The proportion of total U.S. imports from various countries is shown at the bottom of Exhibit 2.4. Canada, China, Mexico, and Japan are the key exporters to the United States: Together, they are responsible for more than half of the value of all U.S. imports.

U.S. Balance-of-Trade Trend

Recent trends for U.S. exports, U.S. imports, and the U.S. balance of trade are shown in Exhibit 2.5. Notice that the value of U.S. exports and U.S. imports has grown substantially over time. Since 1976, the value of U.S. imports has exceeded the value of U.S. exports, causing a balance-of-trade deficit. Much of the trade deficit is due to a trade imbalance with just two countries, China and Japan. In 2006, U.S. exports to China were about \$55 billion, but imports from China were about \$255 billion, which resulted in a balance-of-trade deficit of \$200 billion with China.

Any country's balance of trade can change substantially over time. Shortly after World War II, the United States experienced a large balance-of-trade surplus because Europe relied on U.S. exports as it was rebuilt. During the last decade, the United States has experienced balance-of-trade deficits because of strong U.S. demand for imported products that are produced at a lower cost than similar products can be produced in the United States.

Should the United States Be Concerned about a Huge Balance-of-Trade Deficit?

If firms, individuals, or government agencies from the United States purchased all their products from U.S. firms, their payments would have resulted in revenue to U.S. firms, which would also contribute to earnings for the shareholders. In addition, if the purchases were directed at U.S. firms, these firms would need to produce more products and could hire more employees. Thus, the U.S. unemployment rate might be lower if U.S. purchases were focused on products produced within the United States.

In reality, the United States sends more than \$200 billion in payments for products per year to other countries than what it receives when selling products to other countries. Thus, international trade has created jobs in foreign countries, which replace some jobs in the United States. However, there are some benefits of international trade for the United States. First, international trade has created some jobs in the United States, especially in industries where U.S. firms have a technology advantage. International trade has caused a shift of production to countries that can produce products more efficiently. In addition, it ensures more competition among the firms that produce products, which forces the firms to keep their prices low.

HTTP://

<http://www.ita.doc.gov>
Access to a variety of trade-related country and sector statistics.

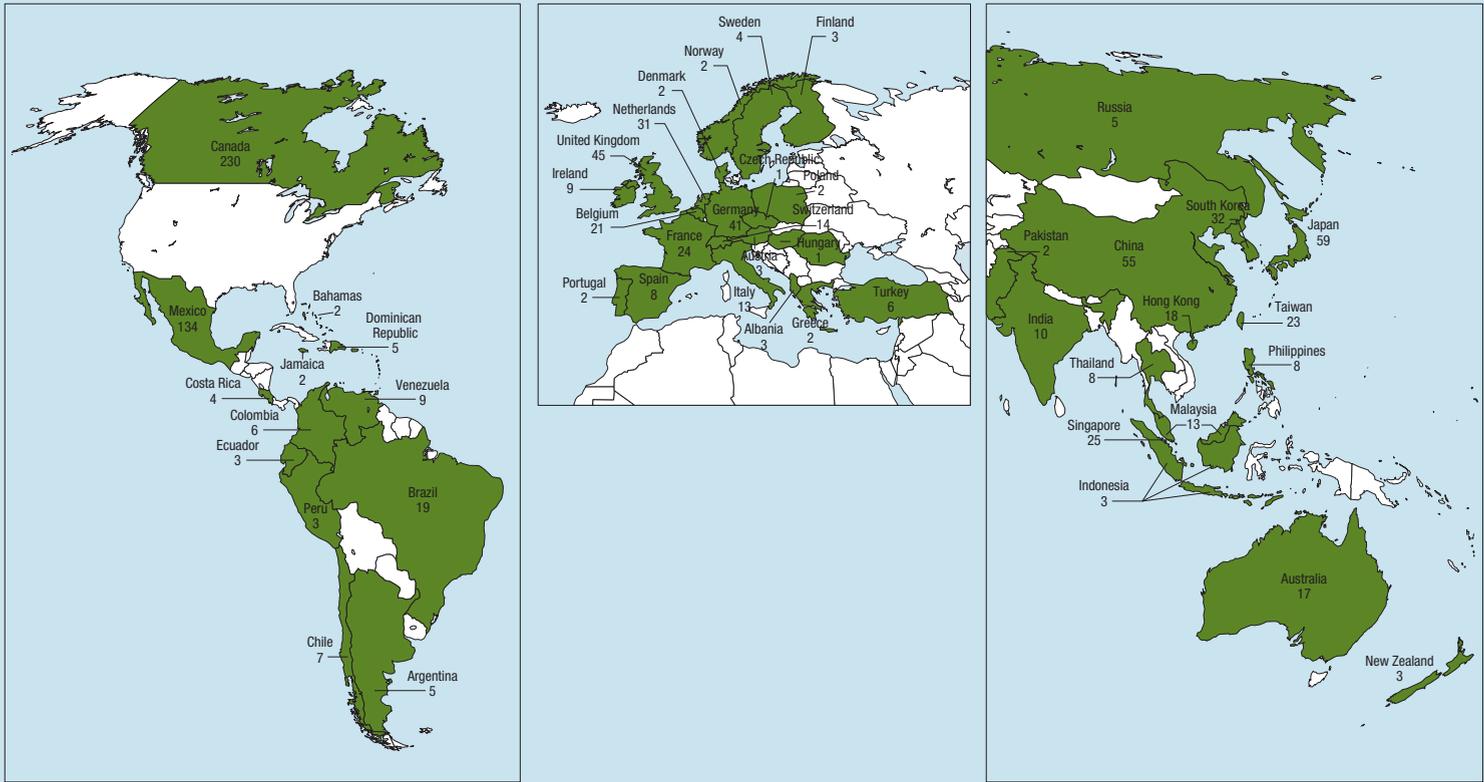
HTTP://

<http://www.census.gov/foreign-trade/balance>
Click on a specific country. The balance of trade with the country you specify is shown for several recent years.

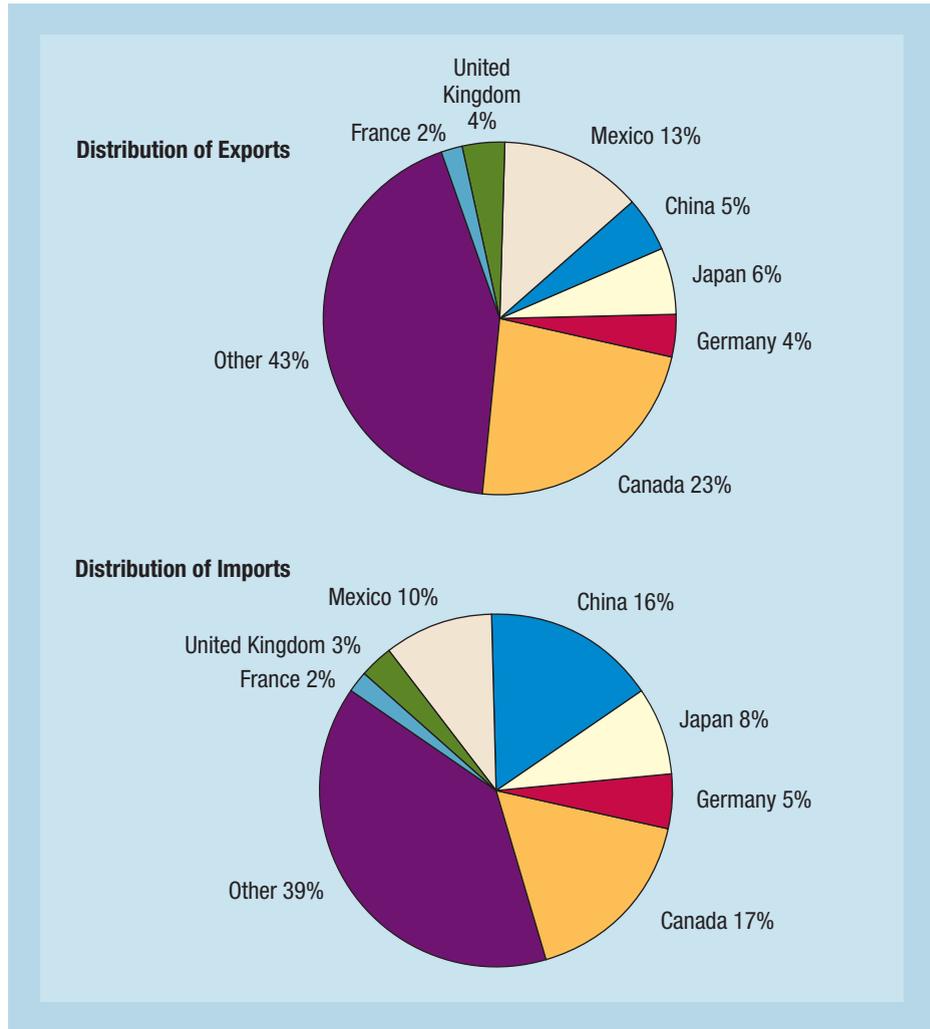
HTTP://

<http://www.census.gov/foreign-trade/www/press.html>
Trend of the U.S. balance of trade in aggregate. Click on U.S. International Trade in Goods and Services. There are several links here to additional details about the U.S. balance of trade.

Exhibit 2.3 Distribution of U.S. Exports across Countries (in billions of \$)



Source: U.S. Census Bureau, 2007.

Exhibit 2.4 2006 Distribution of U.S. Exports and Imports

Source: Federal Reserve, 2007.

International Trade Issues

HTTP://

<http://www.census.gov/foreign-trade/www/press.html>

Click on U.S. International Trade in Goods and Services. There are several links here to additional details about the U.S. balance of trade.

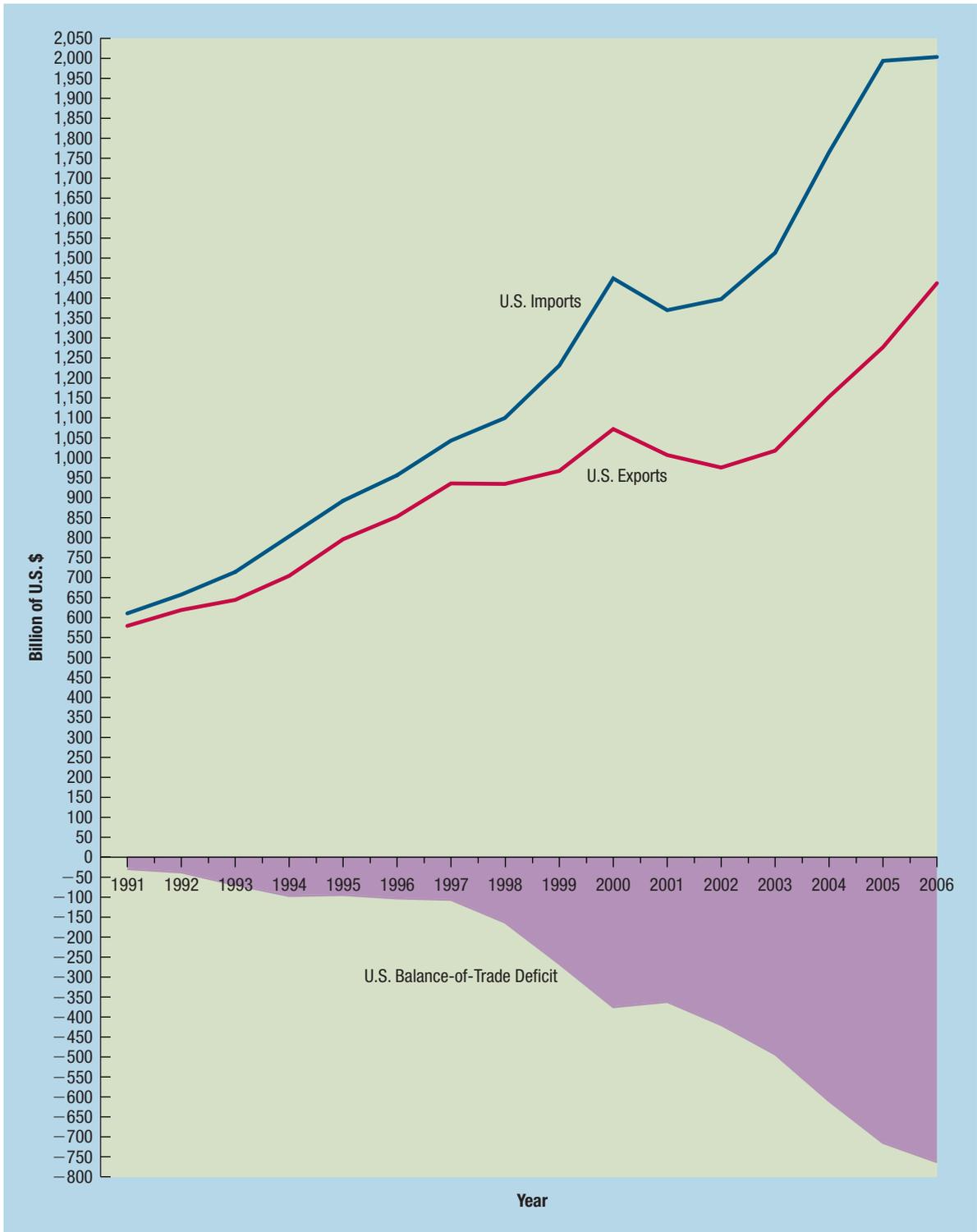
Given the importance of international trade and the potential impact that a government can have on trade, governments continually seek trade policies that are fair to all countries. Much progress has been made as a result of several events that have either reduced or eliminated trade restrictions.

Events That Increased International Trade

The following events reduced trade restrictions and increased international trade.

Removal of the Berlin Wall. In 1989, the Berlin Wall separating East Germany from West Germany was torn down. This was symbolic of new relations between East Germany and West Germany and was followed by the reunification of the two countries. It encouraged free enterprise in all Eastern European countries and the privatization of businesses that were owned by the government. It also led to major reductions in trade barriers in Eastern Europe. Many MNCs began to export

Exhibit 2.5 U.S. Balance of Trade over Time



Source: U.S. Census Bureau, 2007.

products there, while others capitalized on the cheap labor costs by importing supplies from there.

Single European Act. In the late 1980s, industrialized countries in Europe agreed to make regulations more uniform and to remove many taxes on goods traded between these countries. This agreement, supported by the Single European Act of 1987, was followed by a series of negotiations among the countries to achieve uniform policies by 1992. The act allows firms in a given European country greater access to supplies from firms in other European countries.

Many firms, including European subsidiaries of U.S.-based MNCs, have capitalized on the agreement by attempting to penetrate markets in border countries. By producing more of the same product and distributing it across European countries, firms are now better able to achieve economies of scale. Best Foods (now part of Unilever) was one of many MNCs that increased efficiency by streamlining manufacturing operations as a result of the reduction in barriers.

NAFTA. As a result of the North American Free Trade Agreement (NAFTA) of 1993, trade barriers between the United States and Mexico were eliminated. Some U.S. firms attempted to capitalize on this by exporting goods that had previously been restricted by barriers to Mexico. Other firms established subsidiaries in Mexico to produce their goods at a lower cost than was possible in the United States and then sell the goods in the United States. The removal of trade barriers essentially allowed U.S. firms to penetrate product and labor markets that previously had not been accessible.

The removal of trade barriers between the United States and Mexico allows Mexican firms to export some products to the United States that were previously restricted. Thus, U.S. firms that produce these goods are now subject to competition from Mexican exporters. Given the low cost of labor in Mexico, some U.S. firms have lost some of their market share. The effects are most pronounced in the labor-intensive industries.

Within a month after the NAFTA accord, the momentum for free trade continued with a GATT (General Agreement on Tariffs and Trade) accord. This accord was the conclusion of trade negotiations from the so-called Uruguay Round that had begun 7 years earlier. It called for the reduction or elimination of trade restrictions on specified imported goods over a 10-year period across 117 countries. The accord has generated more international business for firms that had previously been unable to penetrate foreign markets because of trade restrictions.

HTTP://

<http://www.ecb.int>
Update of information on
the euro.

Inception of the Euro. In 1999, several European countries adopted the euro as their currency for business transactions between these countries. The euro was phased in as a currency for other transactions during 2001 and completely replaced the currencies of the participating countries on January 1, 2002. Consequently, only the euro is used for transactions in these countries, so firms (including European subsidiaries of U.S.-based MNCs) no longer face the costs and risks associated with converting one currency to another. The single currency system in most of Europe encouraged more trade among European countries.

Expansion of the European Union. In 2004, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia were admitted to the EU, followed by Bulgaria and Romania in 2007. Slovenia adopted the euro as its currency in 2007. The other new members continued to use their own currencies, but may be able to adopt the euro as their currency in the fu-

ture if they meet specified guidelines regarding budget deficits and other financial conditions. Nevertheless, their admission into the EU is relevant because restrictions on their trade with Western Europe are reduced. Since wages in these countries are substantially lower than in Western European countries, many MNCs have established manufacturing plants there to produce products and export them to Western Europe.

Other Trade Agreements. In June 2003, the United States and Chile signed a free trade agreement to remove tariffs on products traded between the two countries. In 2006, the Central American Trade Agreement (CAFTA) was implemented, allowing for lower tariffs and regulations between the United States, the Dominican Republic, and four Central American countries. In addition, there is an initiative for Caribbean nations to create a single market in which there is the free flow of trade, capital, and workers across countries. The United States has also established trade agreements with many other countries.

Trade Friction

International trade policies partially determine which firms get most of the market share within an industry. These policies affect each country's unemployment level, income level, and economic growth. Even though trade treaties have reduced tariffs and quotas over time, most countries still impose some type of trade restrictions on particular products in order to protect their local firms.

An easy way to start an argument among students (or professors) is to ask what they think the policy on international trade should be. People whose job prospects are highly influenced by international trade tend to have very strong opinions about international trade policy. On the surface, most people agree that free trade can be beneficial because it encourages more intense competition among firms, which enables consumers to obtain products where the quality is highest and the prices are low. Free trade should cause a shift in production to those countries where it can be done most efficiently. Each country's government wants to increase its exports because more exports result in a higher level of production and income and may create jobs. However, a job created in one country may be lost in another, which causes countries to battle for a greater share of the world's exports.

People disagree on the type of strategies a government should be allowed to use to increase its respective country's share of the global market. They may agree that a tariff or quota on imported goods prevents free trade and gives local firms an unfair advantage in their own market. Yet, they disagree on whether governments should be allowed to use other more subtle trade restrictions against foreign firms or provide incentives that give local firms an unfair advantage in the battle for global market share. Consider the following situations that commonly occur:

1. The firms based in one country are not subject to environmental restrictions and, therefore, can produce at a lower cost than firms in other countries.
2. The firms based in one country are not subject to child labor laws and are able to produce products at a lower cost than firms in other countries by relying mostly on children to produce the products.
3. The firms based in one country are allowed by their government to offer bribes to large customers when pursuing business deals in a particular industry. They have a competitive advantage over firms in other countries that are not allowed to offer bribes.
4. The firms in one country receive subsidies from the government, as long as they export the products. The exporting of products that were produced with the help

of government subsidies is commonly referred to as **dumping**. These firms may be able to sell their products at a lower price than any of their competitors in other countries.

5. The firms in one country receive tax breaks if they are in specific industries. This practice is not necessarily a subsidy, but it still is a form of government financial support.

In all of these situations, firms in one country may have an advantage over firms in other countries. Every government uses some strategies that may give its local firms an advantage in the fight for global market share. Thus, the playing field in the battle for global market share is probably not even across all countries. Yet, there is no formula that will ensure a fair battle for market share. Regardless of the progression of international trade treaties, governments will always be able to find strategies that can give their local firms an edge in exporting. Suppose, as an extreme example, that a new international treaty outlawed all of the strategies described above. One country's government could still try to give its local firms a trade advantage by attempting to maintain a relatively weak currency. This strategy can increase foreign demand for products produced locally because products denominated in a weak currency can be purchased at a low price.

Using the Exchange Rate as a Policy. At any given point in time, a group of exporters may claim that they are being mistreated and lobby their government to adjust the currency so that their exports will not be so expensive for foreign purchasers. In 2004, European exporters claimed that they were at a disadvantage because the euro was too strong. Meanwhile, U.S. exporters still claimed that they could not compete with China because the Chinese currency (yuan) was maintained at an artificially weak level. In July 2005, China revalued the yuan by 2.1 percent against the dollar in response to criticism. It also implemented a new system in which the yuan could float within narrow boundaries based on a set of major currencies. In May 2007, China widened the band so that the yuan could deviate by as much as .5 percent within a day. This had a very limited effect on the relative pricing of Chinese versus U.S. products and, therefore, on the balance of trade between the two countries.

Outsourcing. One of the most recent issues related to trade is the outsourcing of services. For example, technology support of computer systems used in the United States may be outsourced to India, Bulgaria, China, or other countries where labor costs are low. Outsourcing affects the balance of trade because it means that a service is purchased in another country. This form of international trade allows MNCs to conduct operations at a lower cost. However, it shifts jobs to other countries and is criticized by the people who lose their jobs due to the outsourcing. Many people have opinions about outsourcing, which are often inconsistent with their own behavior.

HTTP://

http://www.worldbank.org/data/wdi2000/pdfs/tab6_5.pdf

Trade statistics within a specific trading block.

EXAMPLE

As a U.S. citizen, Rick says he is embarrassed by U.S. firms that outsource their labor services to other countries as a means of increasing their value because this practice eliminates jobs in the United States. Rick is president of Atlantic Co. and says the company will never outsource its services. Atlantic Co. imports most of its materials from a foreign company. It also owns a factory in Mexico, and the materials produced in Mexico are exported to the United States.

Rick recognizes that outsourcing may replace jobs in the United States. Yet, he does not realize that importing materials or operating a factory in Mexico may also have replaced jobs in the United States. If questioned about his use of foreign labor markets for materials or production, he would likely explain that the high manufacturing wages in the United States force him

to rely on lower-cost labor in foreign countries. Yet, the same argument could be used by other U.S. firms that outsource services.

Rick owns a Toyota, a Nokia cell phone, a Toshiba computer, and Adidas clothing. He argues that these non-U.S. products are a better value for the money than U.S. products. Nicole, a friend of Rick, suggests that his consumption choices are inconsistent with his “create U.S. jobs” philosophy. She explains that she only purchases U.S. products. She owns a Ford (produced in Mexico), a Motorola telephone (components produced in Asia), a Compaq computer (produced in China), and Nike clothing (produced in Indonesia). ■

GOVERNANCE

Should Managers Outsource to Satisfy Shareholders?

Managers of a U.S.-based MNC may argue that they produce their products in the United States to create jobs for U.S. workers. However, when the same products can be easily duplicated in foreign markets for one-fifth of the cost, shareholders may pressure the managers to establish a foreign subsidiary or to engage in outsourcing. Shareholders may suggest that the managers are not maximizing the MNC’s value as a result of their commitment to creating U.S. jobs. The MNC’s board of directors governs the major managerial decisions and could pressure the managers to have some of the production moved outside the United States. The board should consider the potential savings that could occur as a result of having products produced outside the United States. However, it must also consider the possible adverse effects due to bad publicity or to bad morale that could occur among the U.S. workers. If the production cost could be substantially reduced outside the United States without a loss in quality, a possible compromise is to allow foreign production to accommodate any growth in its business. In this way, the strategy would not adversely affect the existing employees involved in production. ■

Using Trade and Foreign Ownership Policies for Security Reasons. Some U.S. politicians have argued that international trade and foreign ownership should be restricted when U.S. security is threatened. While the general opinion has much support, there is disagreement regarding the specific business transactions in which U.S. businesses deserve protection from foreign competition. Consider the following questions:

1. Should the United States purchase military planes only from a U.S. producer of planes, even when Brazil could produce the same planes for half the price? The tradeoff involves a larger budget deficit for increased security. Is the United States truly safer with planes produced in the United States? Are technology secrets safer when the production is in the United States by a U.S. firm?
2. If you think military planes should be produced only by a U.S. firm, should there be any restrictions on foreign ownership of the firm? Foreign investors own a proportion of most large publicly traded companies in the United States.
3. Should foreign ownership restrictions be imposed only on investors based in some countries? Or is there a concern that owners based in any foreign country should be banned from doing business transactions when U.S. security is threatened? What is the threat? Is it that the owners could sell technology secrets to enemies? If so, isn’t such a threat also possible for U.S. owners? If some foreign owners are acceptable, what countries would be acceptable?
4. What products should be viewed as a threat to U.S. security? For example, even if military planes were required to be produced by U.S. firms, what about all the components that are used within the production of the planes? Some of the components used in U.S. military plane production are produced in China and imported by the plane manufacturers.

To realize the degree of disagreement about these issues, try to get a consensus answer on any of these questions from your fellow students in a single classroom. If students without hidden agendas cannot agree on the answer, consider the level of disagreement among owners or employees of U.S. and foreign firms that have much to gain (or lose) from the international trade and investment policy that is implemented. It is difficult to distinguish between a trade or investment restriction that is enhancing national security versus one that is unfairly protecting a U.S. firm from foreign competition. The same dilemma regarding international trade and investment policies to protect national security in the United States also applies to all other countries.

Using Trade Policies for Political Reasons. International trade policy issues have become even more contentious over time as people have come to expect that trade policies will be used to punish countries for various actions. People expect countries to restrict imports from countries that fail to enforce environmental laws or child labor laws, initiate war against another country, or are unwilling to participate in a war against an unlawful dictator of another country. Every international trade convention now attracts a large number of protesters, all of whom have their own agendas. International trade may not even be the focus of each protest, but it is often thought to be the potential solution to the problem (at least in the mind of that protester). Although all of the protesters are clearly dissatisfied with existing trade policies, there is no consensus as to what trade policies should be. These different views are similar to the disagreements that occur between government representatives when they try to negotiate international trade policy.

The managers of each MNC cannot be responsible for resolving these international trade policy conflicts. However, they should at least recognize how a particular international trade policy affects their competitive position in the industry and how changes in policy could affect their position in the future.

Factors Affecting International Trade Flows

Because international trade can significantly affect a country's economy, it is important to identify and monitor the factors that influence it. The most influential factors are:

- Inflation
- National income
- Government policies
- Exchange rates

HTTP://

<http://www.census.gov>
Latest economic, financial, socioeconomic, and political surveys and statistics.

Impact of Inflation

If a country's inflation rate increases relative to the countries with which it trades, its current account will be expected to decrease, other things being equal. Consumers and corporations in that country will most likely purchase more goods overseas (due to high local inflation), while the country's exports to other countries will decline.

HTTP://

<http://research.stlouisfed.org/fred2>
Information about international trade, international transactions, and the balance of trade.

Impact of National Income

If a country's income level (national income) increases by a higher percentage than those of other countries, its current account is expected to decrease, other things being equal. As the real income level (adjusted for inflation) rises, so does consumption of goods. A percentage of that increase in consumption will most likely reflect an increased demand for foreign goods.

HTTP://

<http://www.dataweb.usitc.gov>

Information about tariffs on imported products. Click on any country listed, and then click on Trade Regulations. Review the import controls set by that country's government.

Impact of Government Policies

A country's government can have a major effect on its balance of trade due to its policies on subsidizing exporters, restrictions on imports, or lack of enforcement on piracy.

Subsidies for Exporters. Some governments offer subsidies to their domestic firms, so that those firms can produce products at a lower cost than their global competitors. Thus, the demand for the exports produced by those firms is higher as a result of subsidies.

E X A M P L E

Many firms in China commonly receive free loans or free land from the government. These firms incur a lower cost of operations and are able to price their products lower as a result, which enables them to capture a larger share of the global market. ■

Some subsidies are more obvious than others. It could be argued that every government provides subsidies in some form.

HTTP://

http://www.worldbank.org/data/wdi2000/pdfs/tab6_6.pdf

Detailed information about tariffs imposed by each country.

A country's government can prevent or discourage imports from other countries. By imposing such restrictions, the government disrupts trade flows. Among the most commonly used trade restrictions are tariffs and quotas.

Restrictions on Imports. If a country's government imposes a tax on imported goods (often referred to as a **tariff**), the prices of foreign goods to consumers are effectively increased. Tariffs imposed by the U.S. government are on average lower than those imposed by other governments. Some industries, however, are more highly protected by tariffs than others. American apparel products and farm products have historically received more protection against foreign competition through high tariffs on related imports.

In addition to tariffs, a government can reduce its country's imports by enforcing a **quota**, or a maximum limit that can be imported. Quotas have been commonly applied to a variety of goods imported by the United States and other countries.

HTTP://

<http://www.commerce.gov>
General information about import restrictions and other trade-related information.

HTTP://

<http://www.treas.gov/ofac>
An update of sanctions imposed by the U.S. government on specific countries.

Lack of Restrictions on Piracy. In some cases, a government can affect international trade flows by its lack of restrictions on piracy.

E X A M P L E

In China, piracy is very common. Individuals (called pirates) manufacture CDs and DVDs that look almost exactly like the original product produced in the United States and other countries. They sell the CDs and DVDs on the street at a price that is lower than the original product. They even sell the CDs and DVDs to retail stores. Consequently, local consumers obtain copies of imports rather than actual imports. According to the U.S. film industry, 90 percent of the DVDs that were the intellectual property of U.S. firms and purchased in China may be pirated. It has been estimated that U.S. producers of film, music, and software lose \$2 billion in sales per year due to piracy in China. The Chinese government has periodically stated that it would attempt to crack down, but piracy is still prevalent. ■

As a result of piracy, China's demand for imports is lower. Piracy is one reason why the United States has a large balance-of-trade deficit with China. However, even if piracy were eliminated, the U.S. trade deficit with China would still be large.

Impact of Exchange Rates

Each country's currency is valued in terms of other currencies through the use of exchange rates, so that currencies can be exchanged to facilitate international trans-

actions. The values of most currencies can fluctuate over time because of market and government forces (as discussed in detail in Chapter 4). If a country's currency begins to rise in value against other currencies, its current account balance should decrease, other things being equal. As the currency strengthens, goods exported by that country will become more expensive to the importing countries. As a consequence, the demand for such goods will decrease.

EXAMPLE

A tennis racket that sells in the United States for \$100 will require a payment of C\$125 by the Canadian importer if the Canadian dollar is valued at $C\$1 = \$.80$. If $C\$1 = \$.70$, it would require a payment of C\$143, which might discourage the Canadian demand for U.S. tennis rackets. A strong local currency is expected to reduce the current account balance if the traded goods are **price-elastic** (sensitive to price changes). ■

Using the tennis racket example above, consider the possible effects if currencies of several countries depreciate simultaneously against the dollar (the dollar strengthens). The U.S. balance of trade can decline substantially.

EXAMPLE

During the 1997–1998 Asian crisis, the exchange rates of Asian currencies declined substantially against the dollar, which caused the prices of Asian products to decline from the perspective of the United States and many other countries. Consequently, the demand for Asian products increased and sometimes replaced the demand for products of other countries. For example, the weakness of the Thai baht during this period caused an increase in the global demand for fish from Thailand and a decline in the demand for similar products from the United States (Seattle). ■

Just as a strong dollar is expected to cause a more pronounced U.S. balance-of-trade deficit as explained above, a weak dollar is expected to reduce the U.S. balance-of-trade deficit. The dollar's weakness lowers the price paid for U.S. goods by foreign customers and can lead to an increase in the demand for U.S. products. A weak dollar also tends to increase the dollar price paid for foreign goods and thus reduces the U.S. demand for foreign goods.

Interaction of Factors

Because the factors that affect the balance of trade interact, their simultaneous influence on the balance of trade is complex. For example, as a high U.S. inflation rate reduces the current account, it places downward pressure on the value of the dollar (as discussed in detail in Chapter 4). Since a weaker dollar can improve the current account, it may partially offset the impact of inflation on the current account.

Correcting a Balance-of-Trade Deficit

A balance-of-trade deficit is not necessarily a problem, as it may enable a country's consumers to benefit from imported products that are less expensive than locally produced products. However, the purchase of imported products implies less reliance on domestic production in favor of foreign production. Thus, it may be argued that a large balance-of-trade deficit causes a transfer of jobs to some foreign countries. Consequently, a country's government may attempt to correct a balance-of-trade deficit.

By reconsidering some of the factors that affect the balance of trade, it is possible to develop some common methods for correcting a deficit. Any policy that will increase foreign demand for the country's goods and services will improve its balance-of-trade position. Foreign demand may increase if export prices become more attractive. This can occur when the country's inflation is low or when its currency's value is reduced, thereby making the prices cheaper from a foreign perspective.

A floating exchange rate could possibly correct any international trade imbalances in the following way. A deficit in a country's balance of trade suggests that the country is spending more funds on foreign products than it is receiving from exports to foreign countries. Because it is selling its currency (to buy foreign goods) in greater volume than the foreign demand for its currency, the value of its currency should decrease. This decrease in value should encourage more foreign demand for its goods in the future.

While this theory seems rational, it does not always work as just described. It is possible that, instead, a country's currency will remain stable or appreciate even when the country has a balance-of-trade deficit.

EXAMPLE

The United States normally experiences a large balance-of-trade deficit, which should place downward pressure on the value of the dollar. Yet, in some years, there is substantial investment in dollar-denominated securities by foreign investors. This foreign demand for the dollar places upward pressure on its value, thereby offsetting the downward pressure caused by the trade imbalance. Thus, a balance-of-trade deficit will not always be corrected by a currency adjustment. ■

Why a Weak Home Currency Is Not a Perfect Solution

Even if a country's home currency weakens, its balance-of-trade deficit will not necessarily be corrected for the following reasons.

Counterpricing by Competitors. When a country's currency weakens, its prices become more attractive to foreign customers, and many foreign companies lower their prices to remain competitive with the country's firms.

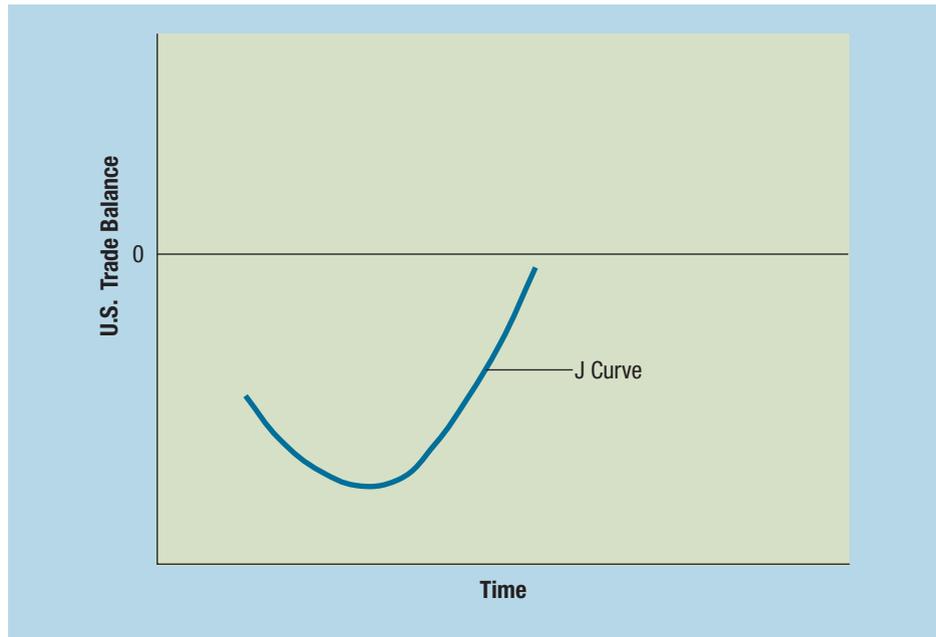
Impact of Other Weak Currencies. The currency does not necessarily weaken against all currencies at the same time.

EXAMPLE

Even if the dollar weakens in Europe, the dollar's exchange rates with the currencies of Hong Kong, Singapore, South Korea, and Taiwan may remain more stable. As some U.S. firms reduce their demand for supplies produced in European countries, they tend to increase their demand for goods produced in Asian countries. Consequently, the dollar's weakness in European countries causes a change in international trade behavior but does not eliminate the U.S. trade deficit. ■

Prearranged International Transactions. Many international trade transactions are prearranged and cannot be immediately adjusted. Thus, exporters and importers are committed to continue the international transactions that they agreed to complete. Over time, non-U.S. firms may begin to take advantage of the weaker dollar by purchasing U.S. imports, if they believe that the weakness will continue. The lag time between the dollar's weakness and the non-U.S. firms' increased demand for U.S. products has sometimes been estimated to be 18 months or even longer.

The U.S. balance of trade may actually deteriorate in the short run as a result of dollar depreciation, since U.S. importers would need more dollars to pay for the imports they contracted to purchase. The U.S. balance of trade only improves when U.S. and non-U.S. importers respond to the change in purchasing power that is caused by the weaker dollar. This pattern is called the **J-curve effect**, and it is illustrated in Exhibit 2.6. The further decline in the trade balance before a reversal creates a trend that can look like the letter J.

Exhibit 2.6 J-Curve Effect

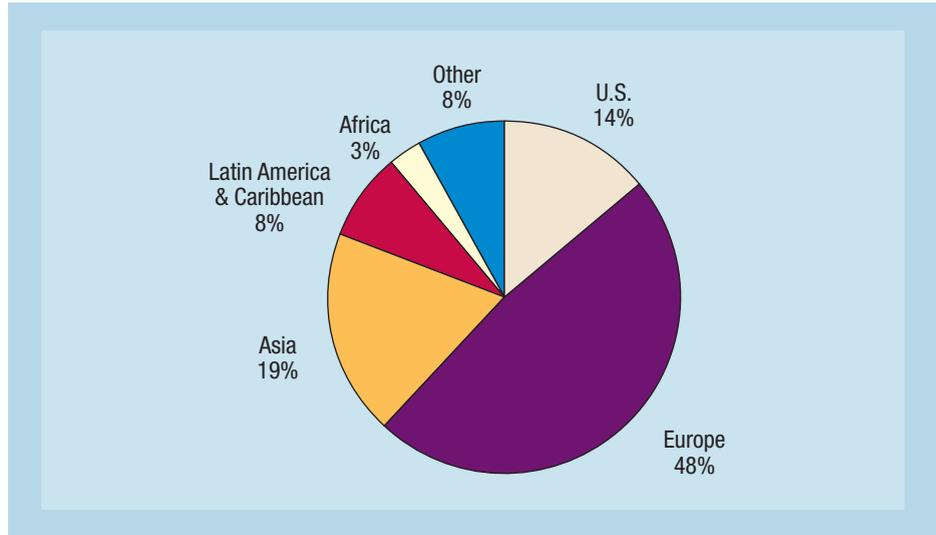
Intracompany Trade. A fourth reason why a weak currency will not always improve a country's balance of trade is that importers and exporters that are under the same ownership have unique relationships. Many firms purchase products that are produced by their subsidiaries in what is referred to as **intracompany trade**. This type of trade makes up more than 50 percent of all international trade. The trade between the two parties will normally continue regardless of exchange rate movements. Thus, the impact of exchange rate movements on intracompany trade patterns is limited.

International Capital Flows

One of the most important types of capital flows is direct foreign investment. Firms commonly attempt to engage in direct foreign investment so that they can reach additional consumers or can rely on low-cost labor. In 2006, the total amount of direct foreign investment (by firms or government agencies all over the world) into all countries was about \$1.2 trillion. Exhibit 2.7 shows a distribution of the regions where the DFI was targeted during 2006. Notice that Europe attracted almost half of the total DFI in 2006. Western European countries attracted most of the DFI, but Eastern European countries such as Poland, Hungary, Slovenia, Croatia, and the Czech Republic also attracted a significant amount of DFI. This is not surprising since these countries are not as developed as those in Western Europe and have more potential for growth. They also have relatively low wages. The United States attracted about \$177 billion in DFI in 2006, or 14 percent of the total DFI.

Distribution of DFI by U.S. Firms

Many U.S.-based MNCs have recently increased their DFI in foreign countries. For example, ExxonMobil, IBM, and Hewlett-Packard have at least 50 percent of their assets in foreign countries. The United Kingdom and Canada are the biggest targets. Europe as a whole receives more than 50 percent of all DFI by U.S. firms. Another

Exhibit 2.7 Distribution of Global DFI across Regions in 2006

Source: United Nations.

30 percent of DFI is focused on Latin America and Canada, while about 16 percent is concentrated in the Asia and Pacific region. The DFI by U.S. firms in Latin American and Asian countries has increased substantially as these countries have opened their markets to U.S. firms.

Distribution of DFI in the United States

Just as U.S. firms have used DFI to enter markets outside the United States, non-U.S. firms have penetrated the U.S. market. Much of the DFI in the United States comes from the United Kingdom, Japan, the Netherlands, Germany, and Canada. Seagram, Food Lion, and some other foreign-owned MNCs generate more than half of their revenue from the United States. Many well-known firms that operate in the United States are owned by foreign companies, including Shell Oil (Netherlands), Citgo Petroleum (Venezuela), Canon (Japan), and Fireman's Fund (Germany). Many other firms operating in the United States are partially owned by foreign companies, including MCI Communications (United Kingdom) and Northwest Airlines (Netherlands). While U.S.-based MNCs consider expanding in other countries, they must also compete with foreign firms in the United States.

Factors Affecting DFI

Capital flows resulting from DFI change whenever conditions in a country change the desire of firms to conduct business operations there. Some of the more common factors that could affect a country's appeal for DFI are identified here.

Changes in Restrictions. During the 1990s, many countries lowered their restrictions on DFI, thereby opening the way to more DFI in those countries. Many U.S.-based MNCs, including Bausch & Lomb, Colgate-Palmolive, and General Electric, have been penetrating less developed countries such as Argentina, Chile, Mexico, India, China, and Hungary. New opportunities in these countries have arisen from the removal of government barriers.

HTTP://

<http://www.privatization.org>
Information about privatizations around the world, commentaries, and related publications.

Privatization. Several national governments have recently engaged in **privatization**, or the selling of some of their operations to corporations and other investors. Privatization is popular in Brazil and Mexico, in Eastern European countries such as Poland and Hungary, and in such Caribbean territories as the Virgin Islands. It allows for greater international business as foreign firms can acquire operations sold by national governments.

Privatization was used in Chile to prevent a few investors from controlling all the shares and in France to prevent a possible reversion to a more nationalized economy. In the United Kingdom, privatization was promoted to spread stock ownership across investors, which allowed more people to have a direct stake in the success of British industry.

The primary reason that the market value of a firm may increase in response to privatization is the anticipated improvement in managerial efficiency. Managers in a privately owned firm can focus on the goal of maximizing shareholder wealth, whereas in a state-owned business, the state must consider the economic and social ramifications of any business decision. Also, managers of a privately owned enterprise are more motivated to ensure profitability because their careers may depend on it. For these reasons, privatized firms will search for local and global opportunities that could enhance their value. The trend toward privatization will undoubtedly create a more competitive global marketplace.

Potential Economic Growth. Countries that have greater potential for economic growth are more likely to attract DFI because firms recognize that they may be able to capitalize on that growth by establishing more business there.

Tax Rates. Countries that impose relatively low tax rates on corporate earnings are more likely to attract DFI. When assessing the feasibility of DFI, firms estimate the after-tax cash flows that they expect to earn.

Exchange Rates. Firms typically prefer to pursue DFI in countries where the local currency is expected to strengthen against their own. Under these conditions, they can invest funds to establish their operations in a country while that country's currency is relatively cheap (weak). Then, earnings from the new operations can periodically be converted back to the firm's currency at a more favorable exchange rate.

Factors Affecting International Portfolio Investment

The desire by individual or institutional investors to direct international portfolio investment to a specific country is influenced by the following factors.

Tax Rates on Interest or Dividends. Investors normally prefer to invest in a country where the taxes on interest or dividend income from investments are relatively low. Investors assess their potential after-tax earnings from investments in foreign securities.

Interest Rates. Portfolio investment can also be affected by interest rates. Money tends to flow to countries with high interest rates, as long as the local currencies are not expected to weaken.

Exchange Rates. When investors invest in a security in a foreign country, their return is affected by (1) the change in the value of the security and (2) the change in the value of the currency in which the security is denominated. If a country's home currency is expected to strengthen, foreign investors may be willing to invest in the country's securities to benefit from the currency movement. Conversely, if

HTTP://

<http://www.worldbank.org>
Information on capital flows and international transactions.

a country's home currency is expected to weaken, foreign investors may decide to purchase securities in other countries. In a period such as 2006, U.S. investors that invested in foreign securities benefited from the change in exchange rates. Since the foreign currencies strengthened against the dollar over time, the foreign securities were ultimately converted to more dollars when they were sold at the end of the year.

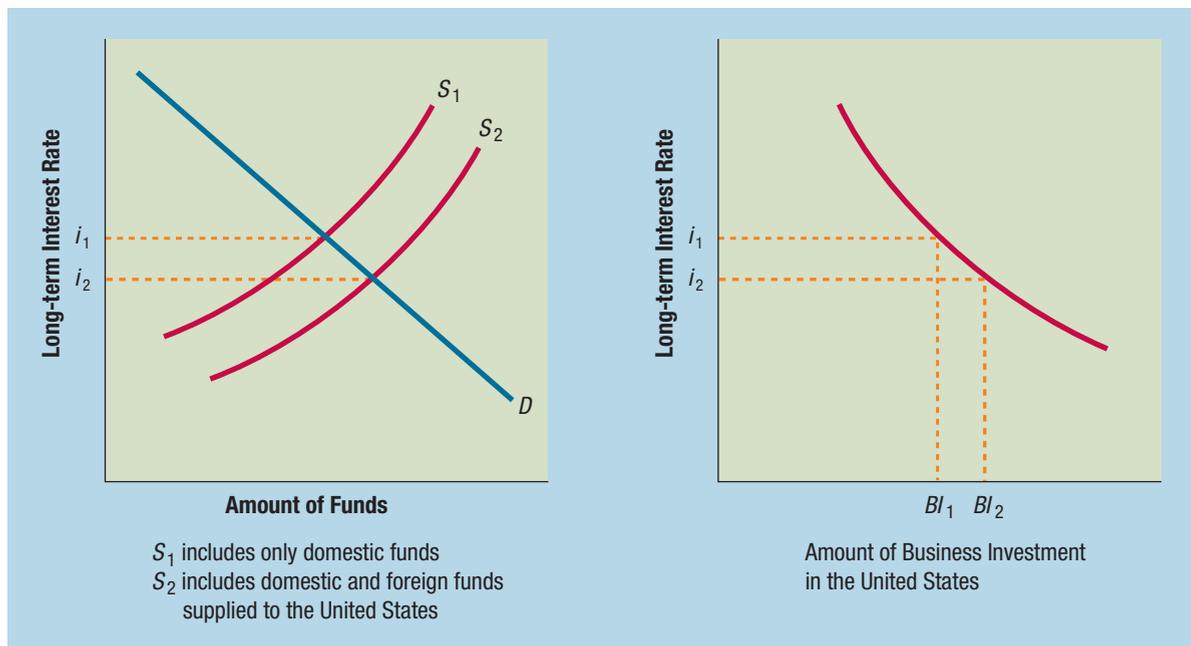
Impact of International Capital Flows

The United States relies heavily on foreign capital in many ways. First, there is foreign investment in the United States to build manufacturing plants, offices, and other buildings. Second, foreign investors purchase U.S. debt securities issued by U.S. firms and therefore serve as creditors to these firms. Third, foreign investors purchase Treasury debt securities and therefore serve as creditors to the U.S. government.

Foreign investors are especially attracted to the U.S. financial markets when the interest rate in their home country is substantially lower than that in the United States. For example, Japan's annual interest rate has been close to 1 percent for several years because the supply of funds in its credit market has been very large. At the same time, Japan's economy has been stagnant, so the demand for funds to support business growth has been limited. Given the low interest rates in Japan, many Japanese investors invested their funds in the United States to earn a higher interest rate.

The impact of international capital flows on the U.S. economy is shown in Exhibit 2.8. At a given point in time, the long-term interest rate in the United States is determined by the interaction between the supply of funds available in U.S. credit markets and the amount of funds demanded there. The supply curve S_1 in the left graph reflects the supply of funds from domestic sources. If the United States relied solely on domestic sources for its supply, its equilibrium interest rate would be i_1 and the level of business investment in the United States (shown in the right graph) would be BI_1 . But since the supply curve also includes the supply of funds from foreign sources (as shown in S_2), the equilibrium interest rate is i_2 . Because of the large

Exhibit 2.8 Impact of the International Flow of Funds on U.S. Interest Rates and Business Investment in the United States



amount of international capital flows that are provided to the U.S. credit markets, interest rates in the United States are lower than what they would be otherwise. This allows for a lower cost of borrowing and therefore a lower cost of using capital. Consequently, the equilibrium level of business investment is BI_2 . Because of the lower interest rate, there are more business opportunities that deserve to be funded.

Consider the long-term rate shown here as the cost of borrowing by the most creditworthy firms. Other firms would have to pay a premium above that rate. Without the international capital flows, there would be less funding available in the United States across all risk levels, and the cost of funding would be higher regardless of the firm's risk level. This would reduce the amount of feasible business opportunities in the United States.

Does the United States Rely Too Much on Foreign Funds? If Japan and China stopped investing in U.S. debt securities, the U.S. interest rates would possibly rise, and investors from other countries would be attracted to the relatively high U.S. interest rate. Thus, the United States would still be able to obtain funding for its debt, but its interest rates (cost of borrowing) may be higher.

In general, access to international funding has allowed more growth in the U.S. economy over time, but it also makes the United States more reliant on foreign investors for funding. The United States should be able to rely on substantial foreign funding in the future as long as the U.S. government and firms are still perceived to be creditworthy. If that trust is ever weakened, the U.S. government and firms would only be able to obtain foreign funding if they paid a higher interest rate to compensate for the risk (a risk premium).

Agencies That Facilitate International Flows

A variety of agencies have been established to facilitate international trade and financial transactions. These agencies often represent a group of nations. A description of some of the more important agencies follows.

HTTP://

<http://www.imf.org>
The latest international economic news, data, and surveys.

International Monetary Fund

The United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire, in July 1944, was called to develop a structured international monetary system. As a result of this conference, the **International Monetary Fund (IMF)** was formed. The major objectives of the IMF, as set by its charter, are to (1) promote cooperation among countries on international monetary issues, (2) promote stability in exchange rates, (3) provide temporary funds to member countries attempting to correct imbalances of international payments, (4) promote free mobility of capital funds across countries, and (5) promote free trade. It is clear from these objectives that the IMF's goals encourage increased internationalization of business.

The IMF is overseen by a Board of Governors, composed of finance officers (such as the head of the central bank) from each of the 185 member countries. It also has an executive board composed of 24 executive directors representing the member countries. This board is based in Washington, D.C., and meets at least three times a week to discuss ongoing issues.

One of the key duties of the IMF is its **compensatory financing facility (CFF)**, which attempts to reduce the impact of export instability on country economies. Although it is available to all IMF members, this facility is used mainly by developing countries. A country experiencing financial problems due to reduced export earnings must demonstrate that the reduction is temporary and beyond its control. In addition, it must be willing to work with the IMF in resolving the problem.

Each member country of the IMF is assigned a quota based on a variety of factors reflecting that country's economic status. Members are required to pay this assigned quota. The amount of funds that each member can borrow from the IMF depends on its particular quota.

The financing by the IMF is measured in **special drawing rights (SDRs)**. The SDR is not a currency but simply a unit of account. It is an international reserve asset created by the IMF and allocated to member countries to supplement currency reserves. The SDR's value fluctuates in accordance with the value of major currencies.

The IMF played an active role in attempting to reduce the adverse effects of the Asian crisis. In 1997 and 1998, it provided funding to various Asian countries in exchange for promises from the respective governments to take specific actions intended to improve economic conditions.

Funding Dilemma of the IMF. The IMF typically specifies economic reforms that a country must satisfy to receive IMF funding. In this way, the IMF attempts to ensure that the country uses the funds properly. However, some countries want funding without adhering to the economic reforms required by the IMF.

EXAMPLE

During the Asian crisis, the IMF agreed to provide \$43 billion to Indonesia. The negotiations were tense, as the IMF demanded that President Suharto break up some of the monopolies run by his friends and family members and close some weak banks. Citizens of Indonesia interpreted the bank closures as a banking crisis and began to withdraw their deposits from all banks. In January 1998, the IMF demanded many types of economic reform, and Suharto agreed to them. The reforms may have been overly ambitious, however, and Suharto failed to institute them. The IMF agreed to renegotiate the terms in March 1998 in a continuing effort to rescue Indonesia, but this effort signaled that a country did not have to meet the terms of its agreement to obtain funding. A new agreement was completed in April, and the IMF resumed its payments to support a bailout of Indonesia. In May 1998, Suharto abruptly discontinued subsidies for gasoline and food, which led to riots. Suharto blamed the riots on the IMF and on foreign investors who wanted to acquire assets in Indonesia at depressed prices. ■

HTTP://

<http://www.worldbank.org>
Website of the World Bank Group.

World Bank

The **International Bank for Reconstruction and Development (IBRD)**, also referred to as the **World Bank**, was established in 1944. Its primary objective is to make loans to countries to enhance economic development. For example, the World Bank recently extended a loan to Mexico for about \$4 billion over a 10-year period for environmental projects to facilitate industrial development near the U.S. border. Its main source of funds is the sale of bonds and other debt instruments to private investors and governments. The World Bank has a profit-oriented philosophy. Therefore, its loans are not subsidized but are extended at market rates to governments (and their agencies) that are likely to repay them.

A key aspect of the World Bank's mission is the **Structural Adjustment Loan (SAL)**, established in 1980. The SALs are intended to enhance a country's long-term economic growth. For example, SALs have been provided to Turkey and to some less developed countries that are attempting to improve their balance of trade.

Because the World Bank provides only a small portion of the financing needed by developing countries, it attempts to spread its funds by entering into **cofinancing agreements**. Cofinancing is performed in the following ways:

- *Official aid agencies.* Development agencies may join the World Bank in financing development projects in low-income countries.

- *Export credit agencies.* The World Bank cofinances some capital-intensive projects that are also financed through export credit agencies.
- *Commercial banks.* The World Bank has joined with commercial banks to provide financing for private-sector development. In recent years, more than 350 banks from all over the world have participated in cofinancing, including Bank of America, J.P. Morgan Chase, and Citigroup.

The World Bank recently established the **Multilateral Investment Guarantee Agency (MIGA)**, which offers various forms of political risk insurance. This is an additional means (along with its SALs) by which the World Bank can encourage the development of international trade and investment.

The World Bank is one of the largest borrowers in the world; its borrowings have amounted to the equivalent of \$70 billion. Its loans are well diversified among numerous currencies and countries. It has received the highest credit rating (AAA) possible.

World Trade Organization

The **World Trade Organization (WTO)** was created as a result of the Uruguay Round of trade negotiations that led to the GATT accord in 1993. This organization was established to provide a forum for multilateral trade negotiations and to settle trade disputes related to the GATT accord. It began its operations in 1995 with 81 member countries, and more countries have joined since then. Member countries are given voting rights that are used to make judgments about trade disputes and other issues.

International Financial Corporation

In 1956 the **International Financial Corporation (IFC)** was established to promote private enterprise within countries. Composed of a number of member nations, the IFC works to promote economic development through the private rather than the government sector. It not only provides loans to corporations but also purchases stock, thereby becoming part owner in some cases rather than just a creditor. The IFC typically provides 10 to 15 percent of the necessary funds in the private enterprise projects in which it invests, and the remainder of the project must be financed through other sources. Thus, the IFC acts as a catalyst, as opposed to a sole supporter, for private enterprise development projects. It traditionally has obtained financing from the World Bank but can borrow in the international financial markets.

International Development Association

The **International Development Association (IDA)** was created in 1960 with country development objectives somewhat similar to those of the World Bank. Its loan policy is more appropriate for less prosperous nations, however. The IDA extends loans at low interest rates to poor nations that cannot qualify for loans from the World Bank.

HTTP://

<http://www.bis.org>
Information on the role of the BIS and the various activities in which it is involved.

Bank for International Settlements

The **Bank for International Settlements (BIS)** attempts to facilitate cooperation among countries with regard to international transactions. It also provides assistance to countries experiencing a financial crisis. The BIS is sometimes referred to as the “central banks’ central bank” or the “lender of last resort.” It played an important role in supporting some of the less developed countries during the international debt crisis in the early and mid-1980s. It commonly provides financing for central banks in Latin American and Eastern European countries.

HTTP://

<http://www.oecd.org>
Summarizes the role and activities of the OECD.

Organization for Economic Cooperation and Development

The Organization for Economic Cooperation and Development (OECD) facilitates governance in governments and corporations of countries with market economics. It has 30 member countries and has relationships with numerous countries. The OECD promotes international country relationships that lead to globalization.

Regional Development Agencies

Several other agencies have more regional (as opposed to global) objectives relating to economic development. These include, for example, the Inter-American Development Bank (focusing on the needs of Latin America), the Asian Development Bank (established to enhance social and economic development in Asia), and the African Development Bank (focusing on development in African countries).

In 1990, the European Bank for Reconstruction and Development was created to help the Eastern European countries adjust from communism to capitalism. Twelve Western European countries hold a 51 percent interest, while Eastern European countries hold a 13.5 percent interest. The United States is the biggest shareholder, with a 10 percent interest. There are 40 member countries in aggregate.

How International Trade Affects an MNC's Value

An MNC's value can be affected by international trade in several ways. The cash flows (and therefore the value) of an MNC's subsidiaries that export to a specific country are typically expected to increase in response to a higher inflation rate (causing local substitutes to be more expensive) or a higher national income (which increases the level of spending) in that country. The expected cash flows of the MNC's subsidiaries that export or import may increase as a result of country trade agreements that reduce tariffs or other trade barriers.

Cash flows to a U.S.-based MNC that occur in the form of payments for exports manufactured in the United States are expected to increase as a result of a weaker dollar because the demand for its dollar-denominated exports should increase. However, cash flows of U.S.-based importers may be reduced by a weaker dollar because it will take more dollars (increased cash outflows) to purchase the imports. A stronger dollar will have the opposite effects on cash flows of U.S.-based MNCs involved in international trade.

SUMMARY

■ The key components of the balance of payments are the current account and the capital account. The current account is a broad measure of the country's international trade balance. The capital account is a measure of the country's long-term and short-term capital investments, including direct foreign investment and investment in securities (portfolio investment).

■ A country's international trade flows are affected by inflation, national income, government restrictions, and exchange rates. High inflation, a high national income, low or no restrictions on imports, and a strong local currency tend to result in a strong demand for imports and a current account deficit. Although some countries attempt to correct cur-

rent account deficits by reducing the value of their currencies, this strategy is not always successful.

■ A country's international capital flows are affected by any factors that influence direct foreign investment or portfolio investment. Direct foreign investment tends to occur in those countries that have

no restrictions and much potential for economic growth. Portfolio investment tends to occur in those countries where taxes are not excessive, where interest rates are high, and where the local currencies are not expected to weaken.

POINT COUNTER-POINT

Should Trade Restrictions Be Used to Influence Human Rights Issues?

Point Yes. Some countries do not protect human rights in the same manner as the United States. At times, the United States should threaten to restrict U.S. imports from or investment in a particular country if it does not correct human rights violations. The United States should use its large international trade and investment as leverage to ensure that human rights violations do not occur. Other countries with a history of human rights violations are more likely to honor human rights if their economic conditions are threatened.

Counter-Point No. International trade and human rights are two separate issues. International trade should not be used as the weapon to enforce human rights. Firms engaged in international trade should not

be penalized by the human rights violations of a government. If the United States imposes trade restrictions to enforce human rights, the country will retaliate. Thus, the U.S. firms that export to that foreign country will be adversely affected. By imposing trade sanctions, the U.S. government is indirectly penalizing the MNCs that are attempting to conduct business in specific foreign countries. Trade sanctions cannot solve every difference in beliefs or morals between the more developed countries and the developing countries. By restricting trade, the United States will slow down the economic progress of developing countries.

Who Is Correct? Use the Internet to learn more about this issue. Which argument do you support? Offer your own opinion on this issue.

SELF TEST

Answers are provided in Appendix A at the back of the text.

- Briefly explain how changes in various economic factors affect the U.S. current account balance.
- Explain why U.S. tariffs may change the composition of U.S. exports but will not necessarily reduce a U.S. balance-of-trade deficit.

- Explain how the Asian crisis affected trade between the United States and Asia.

QUESTIONS AND APPLICATIONS

1. Balance of Payments.

- Of what is the current account generally composed?
- Of what is the capital account generally composed?

2. Inflation Effect on Trade.

- How would a relatively high home inflation rate affect the home country's current account, other things being equal?

- b. Is a negative current account harmful to a country? Discuss.
3. **Government Restrictions.** How can government restrictions affect international payments among countries?
4. **IMF.**
- What are some of the major objectives of the IMF?
 - How is the IMF involved in international trade?
5. **Exchange Rate Effect on Trade Balance.** Would the U.S. balance-of-trade deficit be larger or smaller if the dollar depreciates against all currencies, versus depreciating against some currencies but appreciating against others? Explain.
6. **Demand for Exports.** A relatively small U.S. balance-of-trade deficit is commonly attributed to a strong demand for U.S. exports. What do you think is the underlying reason for the strong demand for U.S. exports?
7. **Change in International Trade Volume.** Why do you think international trade volume has increased over time? In general, how are inefficient firms affected by the reduction in trade restrictions among countries and the continuous increase in international trade?
8. **Effects of the Euro.** Explain how the existence of the euro may affect U.S. international trade.
9. **Currency Effects.** When South Korea's export growth stalled, some South Korean firms suggested that South Korea's primary export problem was the weakness in the Japanese yen. How would you interpret this statement?
10. **Effects of Tariffs.** Assume a simple world in which the United States exports soft drinks and beer to France and imports wine from France. If the United States imposes large tariffs on the French wine, explain the likely impact on the values of the U.S. beverage firms, U.S. wine producers, the French beverage firms, and the French wine producers.

Advanced Questions

11. **Free Trade.** There has been considerable momentum to reduce or remove trade barriers in an effort to achieve "free trade." Yet, one disgruntled executive of an exporting firm stated, "Free trade is not conceivable; we are always at the mercy of the exchange rate. Any country can use this mechanism to impose trade barriers." What does this statement mean?
12. **International Investments.** U.S.-based MNCs commonly invest in foreign securities.
- Assume that the dollar is presently weak and is expected to strengthen over time. How will these expectations affect the tendency of U.S. investors to invest in foreign securities?
 - Explain how low U.S. interest rates can affect the tendency of U.S.-based MNCs to invest abroad.
 - In general terms, what is the attraction of foreign investments to U.S. investors?
13. **Exchange Rate Effects on Trade.**
- Explain why a stronger dollar could enlarge the U.S. balance-of-trade deficit. Explain why a weaker dollar could affect the U.S. balance-of-trade deficit.
 - It is sometimes suggested that a floating exchange rate will adjust to reduce or eliminate any current account deficit. Explain why this adjustment would occur.
 - Why does the exchange rate not always adjust to a current account deficit?

Discussion in the Boardroom

This exercise can be found in Appendix E at the back of this textbook.

Running Your Own MNC

This exercise can be found on the Xtra! website at <http://maduraxtra.swlearning.com>.

BLADES, INC. CASE

Exposure to International Flow of Funds

Ben Holt, chief financial officer (CFO) of Blades, Inc., has decided to counteract the decreasing demand for "Speedos" roller blades by exporting this product to Thailand. Furthermore, due to the low cost of rub-

ber and plastic in Southeast Asia, Holt has decided to import some of the components needed to manufacture "Speedos" from Thailand. Holt feels that importing rubber and plastic components from Thailand will

provide Blades with a cost advantage (the components imported from Thailand are about 20 percent cheaper than similar components in the United States). Currently, approximately \$20 million, or 10 percent, of Blades' sales are contributed by its sales in Thailand. Only about 4 percent of Blades' cost of goods sold is attributable to rubber and plastic imported from Thailand.

Blades faces little competition in Thailand from other U.S. roller blades manufacturers. Those competitors that export roller blades to Thailand invoice their exports in U.S. dollars. Currently, Blades follows a policy of invoicing in Thai baht (Thailand's currency). Ben Holt felt that this strategy would give Blades a competitive advantage, since Thai importers can plan more easily when they do not have to worry about paying differing amounts due to currency fluctuations. Furthermore, Blades' primary customer in Thailand (a retail store) has committed itself to purchasing a certain amount of "Speedos" annually if Blades will invoice in baht for a period of three years. Blades' purchases of components from Thai exporters are currently invoiced in Thai baht.

Ben Holt is rather content with current arrangements and believes the lack of competitors in Thailand, the quality of Blades' products, and its approach to pricing will ensure Blades' position in the Thai roller blade market in the future. Holt also feels that Thai importers will prefer Blades over its competitors because Blades invoices in Thai baht.

You, Blades' financial analyst, have doubts as to Blades' "guaranteed" future success. Although you believe Blades' strategy for its Thai sales and imports is sound, you are concerned about current expecta-

tions for the Thai economy. Current forecasts indicate a high level of anticipated inflation, a decreasing level of national income, and a continued depreciation of the Thai baht. In your opinion, all of these future developments could affect Blades financially given the company's current arrangements with its suppliers and with the Thai importers. Both Thai consumers and firms might adjust their spending habits should certain developments occur.

In the past, you have had difficulty convincing Ben Holt that problems could arise in Thailand. Consequently, you have developed a list of questions for yourself, which you plan to present to the company's CFO after you have answered them. Your questions are listed here:

1. How could a higher level of inflation in Thailand affect Blades (assume U.S. inflation remains constant)?
2. How could competition from firms in Thailand and from U.S. firms conducting business in Thailand affect Blades?
3. How could a decreasing level of national income in Thailand affect Blades?
4. How could a continued depreciation of the Thai baht affect Blades? How would it affect Blades relative to U.S. exporters invoicing their roller blades in U.S. dollars?
5. If Blades increases its business in Thailand and experiences serious financial problems, are there any international agencies that the company could approach for loans or other financial assistance?

SMALL BUSINESS DILEMMA

Identifying Factors That Will Affect the Foreign Demand at the Sports Exports Company

Recall from Chapter 1 that Jim Logan planned to pursue his dream of establishing his own business (called the Sports Exports Company) of exporting footballs to one or more foreign markets. Jim has decided to initially pursue the market in the United Kingdom because British citizens appear to have some interest in football as a possible hobby, and no other firm has capitalized on this idea in the United Kingdom. (The sporting goods shops in the United Kingdom do not sell footballs but might be willing to sell them.) Jim has contacted one sporting goods distributor that has agreed to purchase footballs on a monthly basis and distribute (sell) them to sporting goods stores throughout the United Kingdom. The distributor's demand

for footballs is ultimately influenced by the demand for footballs by British citizens who shop in British sporting goods stores. The Sports Exports Company will receive British pounds when it sells the footballs to the distributor and will then convert the pounds into dollars. Jim recognizes that products (such as the footballs his firm will produce) exported from U.S. firms to foreign countries can be affected by various factors.

Identify the factors that affect the current account balance between the United States and the United Kingdom. Explain how each factor may possibly affect the British demand for the footballs that are produced by the Sports Exports Company.

INTERNET/EXCEL EXERCISES

The website address of the Bureau of Economic Analysis is <http://www.bea.gov>.

1. Use this website to assess recent trends in exporting and importing by U.S. firms. How has the balance of trade changed over the last 12 months?
2. Offer possible reasons for this change in the balance of trade.
3. Go to <http://www.census.gov/foreign-trade/balance/> and obtain monthly balance-of-trade data for the last 24 months between the United States and the United Kingdom or a country specified by your professor. Create an electronic spreadsheet in which the first column is the month of concern, and the second column is the trade balance. (See Appendix C for help with conducting analyses with Excel.) Use a compute statement to derive the percentage change in the trade balance in the third column. Then go to <http://www.oanda.com/convert/fxhistory>. Obtain the direct exchange rate (dollars per currency unit) of the British pound (or

the local currency of the foreign country you select). Obtain the direct exchange rate of the currency at the beginning of each month and insert the data in column 4. Use a compute statement to derive the percentage change in the currency value from one month to the next in column 5. Then apply regression analysis in which the percentage change in the trade balance is the dependent variable and the percentage change in the exchange rate is the independent variable. Is there a significant relationship between the two variables? Is the direction of the relationship as expected? If you think that the exchange rate movements affect the trade balance with a lag (because the transactions of importers and exporters may be booked a few months in advance), you can reconfigure your data to assess that relationship (match each monthly percentage change in the balance of trade with the exchange rate movement that occurred a few months earlier).